# THE EXCHANGE EQUALISATION ACCOUNT

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# THE EXCHANGE EQUALISATION ACCOUNT

BY

N. F. HALL

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# PREFACE

THIS study of the Exchange Equalisation Account does not pretend to be exhaustive. Sufficient information with regard to the Account's activities is not available at the present time to make possible a detailed history. All that has been attempted is an examination of some of the more conspicuous events in monetary affairs since the Account was established, because these events throw some light upon the way in which it has been managed. Certain principles of monetary management under modern conditions emerge and these are examined in the last two chapters. As currency control upon so large a scale has never before been practised, it is a matter of importance not only to this country but to the world at large that the British experiment of the past three years should be discussed as fully as the secrecy which surrounds the Equalisation Account permits. I have had no access to information which is not readily available to the general public, and the views which are expressed are entirely my own.

I should like to take this opportunity of thanking the Editor of the *Economist* for permission to reproduce some of the charts and other matter which appeared

in the special Supplement published by that paper on May 5th, 1934. I should also like to thank my colleague, Mr. Harold Barger, B.A., for very substantial assistance in preparing the statistical material and the charts used in this study, Mr. H. J. Lyons, B.Sc. (Econ.), for general assistance, and my colleague, Dr. P. N. Rosenstein-Rodan, who has read much of the manuscript and made a number of valuable suggestions.

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# CHAPTER I

## INTRODUCTORY

THE institution and operation of an Exchange Equalisation Account by Great Britain in 1932 has played a large part in the economic life of the world in the past two years. It has inevitably become the subject of considerable controversy and discussion, not only in this country, but also in the Press and the legislative assemblies of the United States. Detailed information about the operations of the Account cannot be obtained, but it is, nevertheless, possible by a scrutiny of such data as are available to arrive at general conclusions about the effects which it has had on the international exchanges since its institution, and to form a judgment as to the general considerations which seem to have guided its establishment and operation. The importance of dispassionate discussion on this subject cannot be over-estimated as it must play a considerable part in any plan that may be adopted for the ultimate stabilisation of the pound sterling, while there is always a possibility that the Exchange Equalisation Account, or something like it, may become a more permanent feature of the British monetary system than it was originally intended to be.

The pound sterling in the early spring of 1932 was something of a paradox. It was unstable, and yet it was more attractive to foreigners than the gold standard

currencies. Although the collapse of 1931 was caused by basic weaknesses in the trading position of Great Britain, the rapid fall in the external value of the pound after the gold standard was suspended was largely due to the realisation of the foreign balances, many of them the reserves of other monetary systems, that were held in London. As soon as a substantial part of these balances had been liquidated, it was inevitable that the pound should return into favour as an international monetary unit. It had been through its crisis. Those of the American dollar and the gold standard currencies were yet to come. In the United States the policy of using Government loans to paper over the more obvious cracks in the banking system had already caused hoarding upon a gigantic scale. The European gold currencies had been weakened by the rapid fall of the pound itself, gold prices were still falling steeply, and the budgetary problems of the gold bloc were increasing in consequence. Meanwhile the budgetary policy of the British Government made it clear that no major inflation was to take place in Great Britain. Early in 1932 the pound sterling became once more an attractive currency in which to hold foreign balances. The financial crisis of the pound sterling was over.

Meanwhile, the internal and industrial effects of the breakdown of the gold standard had not been fully felt. Instead of the fall in the exchanges rapidly restoring equilibrium between British costs and prices and those of the rest of the world, the movements during the first few months after the suspension of the gold standard tended to increase the disharmonies. The pace at which the pound fell was dictated by the realisation of sterling balances, and as these were considerable, the first fall was more than enough to remove the over-valuation of

the pound. The resulting under-valuation was necessarily only a temporary phenomenon, as the low rate of exchange caused an immediate rise in the prices of a number of indispensable imports.[1] While this higher level of import prices was being diffused through the whole British cost and income structure, causing it to move upward, non-sterling area prices were being pushed down by the fall in the pound, so that external costs were moving in the opposite direction to British ones. The result, therefore, of the collapse of the exchanges was to widen, and not to narrow, the gap between British and world costs. But early in 1932 it seemed that, as a result of the rapid liquidation of the financial crisis, the pound would rise externally before the internal system had had time to adjust itself to the new level of the exchanges. The help to British exports that had come from the fall in sterling had been substantially offset, because many other countries had followed Britain in leaving the gold standard, and those which had not done so had devised effective protective measures. The dangerous theory that an industrial country can benefit in any lasting way by exchange depreciation had received a sharp set-back. Indeed, it seemed probable that Great Britain would shortly have all the disadvantages of unstable exchanges with the additional burden of an over-valued currency.

The simplest way of meeting the situation in April 1932 would have been a return to gold at a fairly low parity, but there were not sufficient reserves of gold and foreign exchange to make this a practical policy.

[1] The full effect of the fall of the pound was not felt, as a number of countries from which Britain drew her exports followed her off gold. The position of Great Britain and the pound is examined here, however, and not that of the sterling countries and the sterling currencies considered as a whole.

Instead, an Exchange Equalisation Account was set up to prevent excessive movements in the exchanges. Great Britain was to benefit from the improved financial situation while time was given for the industrial position to come into equilibrium with it. It was not desired to discourage foreigners from holding sterling balances if they wished to do so, because the presence of foreign balances in London is an important factor in pushing down short money rates. It was, however, necessary that movements in these balances should not have any substantial influence upon the exchanges, fluctuations in which would cause further disturbances in British costs and prices, thus delaying industrial recovery.

Unstable currencies have usually to be pegged against excessive downward movements. The special position of the pound in 1932, like that of the franc in 1927, made it necessary to peg it against upward movements. Deliberate under-valuation, however, was not desired. The object of the authorities was to prevent changes in foreign balances moving the exchange away from the equilibrium rate at which it was tending to settle under the influence of normal long-term industrial factors. Exchange management to achieve this objective is much less complicated than it appears to be at first sight. The authority simply has to watch the quantities of foreign currency which are being purchased on its behalf at any particular rate of exchange. It has then to examine whether these quantities of foreign currencies are greater or less than the volume of sterling deposits that have been acquired on foreign account during the period. If the volume of foreign currency is greater than the increase in foreign deposits, the rate has been kept too low and must be

allowed to rise; if it is less, then the rate is too high and should be lowered. This will be true, of course, only if the balance of payments is neutral. So long as those responsible for the management of an exchange equalisation account adhere to the principle of not attempting to influence the basic rate of exchange and content themselves with acquiring foreign currencies in proportion to the increase of foreign balances, the industrial factors will come slowly into equilibrium during the period in which it is operating. Such a policy of "offsetting" isolates the financial from the industrial elements in the situation and gives time for the latter to adjust themselves without further disturbances.

As we shall see below, particularly in Chapter VI, there was a tendency towards equilibrium between British and foreign prices after the Account started its operations. This gives us strong circumstantial evidence that the principle of watching the relationship between increases and decreases of foreign balances held in London, and the quantities of foreign currency bought and sold by the Account, was actually followed by those responsible for its management. One further condition has to be fulfilled, however, before adherence to this principle fully meets the situation. It is necessary that the foreign currencies acquired shall not be allowed to increase the supplies of sterling in the London Market. If this occurs, then British costs and prices will be disturbed, not by movements in the rate of exchange, but by alterations in local supplies of money. As the sterling which the Account sold was obtained by sales of Treasury bills which were in great demand owing to the increase in the foreign balances themselves, there were practically no changes in the supply of sterling in the market except when gold was deliberately

transferred from the Account to the Bank of England in conformity with its local credit policy.[1] Thus, the mechanics of the Account, and the principle guiding its operations, were adequate for the purpose of solving the problem of preventing the more rapid financial adjustments prolonging the industrial difficulties caused by the crisis.

There is nothing particularly new or original about the principle that directs the operations of the Account. That wise banking requires the character of deposits as well as their magnitude to influence the size of the cash reserve held against them is an axiom that goes back to Cantillon. The attractiveness of sterling balances to foreigners had complicated the task of monetary management in London ever since the end of the war. The establishment of the Exchange Account gave the British authorities an effective instrument for simplifying their work. It took a crisis to bring into being a piece of machinery which had been needed for half a generation. In Chapter VII the possibility of the Account, or something like it, being retained as part of the permanent machinery of the London Market is discussed. In earlier chapters, an attempt is made to show, after an examination of a number of the practical difficulties of the period 1932–4, that the Account has justified its establishment. But to show that the Account has justified itself is not necessarily to agree that the British monetary policy during the period has been an ideal one. In the most usually accepted sense of the term, there does not seem to have been a British

[1] It should be noticed that the Bank did not on all occasions increase credit when it was able to add to its gold holdings by purchases from the Exchange Account. In July 1932 it seems to have done so. In the early months of 1933 it contented itself with strengthening its reserve position.

monetary policy at all. A number of incidental problems, such as the removal of rapid fluctuations in the exchanges, the funding of the internal debt and the introduction of a régime of really effective "cheap money", have been solved as they have arisen, and solved with a considerable degree of benefit to the economic position of Great Britain. The organisation of the Exchange Equalisation Account has made it possible for the authorities to prevent to some extent the short-term capital movements disturbing either the external value of the pound or short money rates in London. The opening of the Account must be considered, therefore, as an important development in the machinery of London's Money Market, and not as an experiment in monetary policy. The scope of this study is limited to an examination of the organisation of the Account, and of the principle of holding special reserves against external short-term liabilities; it makes no attempt to appraise British monetary policy since 1931. The principle upon which the Account has been operated is, however, a significant one, and the improvement of the machinery of the London Market resulting from the opening of the Account should make it possible for Great Britain to pursue an independent monetary policy in the future.

# CHAPTER II

## THE INTERNAL DEBT AND MONETARY POLICY

Before examining the work which has been done since the establishment of the Exchange Equalisation Account, it is necessary to consider some neglected but important technical problems which have complicated the task of the British monetary authorities since the close of the war, because the significance of the work of the Account itself can only be apparent in the light of the help it has given in the mitigation of the difficulties which the war left behind it. Foremost amongst these was the disturbing influence of the internal debt of the British Government. Unlike the external debt and reparation payments with their obvious direct influences upon the exchanges, the internal debt as a complicating factor in the post-war world has generally been neglected, and the limitations which it has imposed upon monetary policy have been ignored. Meanwhile the Treasury has gone steadily upon its way, improving year by year the general structure of the debt, thus bringing the whole financial system under better control. The following table sets out the proportions to the total of the different classes of debt, and shows the changes that have taken place in these classes since 1924.

These figures call for some comment. Attention has usually been focussed upon the size of the debt and not

## TABLE I

### The Structure of the British National Debt

(Classes of Debt as a percentage of total Internal Debt)

| At March 31st | 1924 | 1926 | 1928 | 1929 | 1930 | 1931 | 1932 | 1933[b] | 1934[b c] |
|---|---|---|---|---|---|---|---|---|---|
| | % | % | % | % | % | % | % | % | % |
| Floating Debt . | 12·6 | 11·6 | 11·3 | 12·2 | 10·5 | 9·9 | 10·3 | 10·4 | 8·1 |
| Short-term Unfunded Debt[a] | 23·2 | 19·8 | 14·6 | 11·5 | 9·0 | 10·2 | 8·3 | 6·9 | 4·1 |
| Long-term Unfunded Debt | 48·2 | 50·8 | 51·9 | 51·9 | 56·3 | 56·0 | 56·7 | 25·9 | 31·6 |
| Funded Debt . | 15·9 | 17·7 | 22·2 | 24·4 | 24·1 | 23·8 | 24·6 | 56·8 | 56·2 |

*Sources.*—Statistical Summary of Bank of England, May 1932, 1933, 1934.

[a] Excluding Savings Certificates.
[b] Treasury Bills issued to Exchange Equalisation Account are excluded.
[c] Position at April 15th, 1934.

on its composition, but, from the point of view of influence upon monetary policy and management, the structure of the debt has been the more important factor in the situation. The special position of Treasury bills, which make up the greater part of the floating debt, and their connection with foreign balances held in sterling, will be examined in the next chapter. During the greater part of the period, they have enabled the Treasury to borrow at relatively low rates of interest, but the number of bills outstanding has tended to decline. The existence of so large a supply of Government paper cannot have been a healthy thing for the Bill Market.[1] The table shows that there has been a general downward tendency in the proportion of total debt existing in this form.

From the point of view of monetary policy, however,

[1] For a further discussion of this point see Appendix I, *Monetary Policy and the Depression*. A first report by a study group of the Royal Institute of International Affairs.

the most significant item is the short-term unfunded debt, which fell from a percentage of 23·2 per cent in 1924 to 4·1 per cent in 1934. The figures in millions of pounds sterling are 1460 and 275 respectively. So large a volume of the debt was kept in this form in order to keep down the annual interest charges falling upon the Budget; but the Treasury seems to have taken every opportunity of stabilising the general situation whenever it could do so without raising the total interest burden. Ever since the war, the Treasury must have been balancing the danger arising from a large unfunded debt against the undesirability of further adding to the fixed burden on the Budget. They have avoided the Scylla of increased interest charges, but they have not escaped the Charybdis of a broken monetary standard.

Some idea of the size of the problem that confronted the British Treasury is suggested by the following figures: on April 1st, 1925, the total Treasury liabilities which, by the terms of their issue, had to be refinanced before the end of the Income Tax year 1933–4 were approximately £1300 million. National War Bonds and Treasury Bonds, carrying relatively high rates of interest, made up a large part of this total. In addition to the issues which had to be refinanced, there was also outstanding a total of approximately £2000 million of War Loan which could be refinanced between 1929 and 1947. By April 1934 the total maturities which the Treasury had to refinance during the coming ten years had been reduced to £650 million. The existence of Treasury liabilities of this character upon so substantial a scale in the period following the return to gold in 1925 complicated very greatly, if it did not render practically impossible, the task of the monetary authorities

in administering the gold standard. Treasury Bills and short-dated bonds acted as a magnet to foreign balances. Foreigners who wished to hold sterling balances could buy on their own account these high yielding short-term securities, which offered little or no prospect of capital loss in the event of a rise in the general level of money rates. If they did not wish to hold them directly themselves, they found British banks and finance houses willing to accept their deposits upon favourable terms because this paper was an excellent earning asset to hold as cover against external deposits.

As these foreign holdings of sterling were desired more for reason of security and liquidity than for the income earned upon them, the immunity of these short-dated Government securities from the hazard of capital depreciation was of very special importance. Indeed, instead of an upward movement of rates being a possible source of danger to foreign holders, it was a further attraction to them, as they could, as their holdings matured, re-invest in securities giving a higher interest return. In the event of money rates falling, there could be no substantial increase in the capital value of these short-term bonds, as their prices could only move up sufficiently to bring the net yield of maturity into line with the level for prime bills. The risks associated with possible future changes in the level of money rates were, therefore, reduced by the excessive supply of short-term Treasury obligations available in the London Market during this period. After the restoration of the gold standard, there seemed to be little or no exchange risk in holding sterling balances. As we shall see below (see page 18) changes in Bank rate tended to alter the form of London's

external liabilities, but had less than normal influence upon their quantity. The effect of the large volume of short-term unfunded Government debt at a time when there were great economic difficulties abroad, was to stabilise the money rate structure in the London Market and to reduce substantially the external reactions to changes in Bank rate.

At the same time, the internal influence of changes in Bank rate was damped down. Short-term Government securities are acceptable cover against Bank advances. If the yield upon these is high, the real cost of borrowing by way of Bank advances is reduced. The borrower can use the interest earned upon the securities hypothecated to the Bank to pay his banker's charges, so that a high Bank rate as a deterrent to further borrowing does not become effective until it is higher than the yield on gilt-edged securities. But to push it substantially above this level will increase the cost of refinancing the floating and unfunded debt. For the central monetary authority there was a conflict between its duties as Government banker and its responsibilities for the internal credit structure. The short date of maturity of many of these securities, in addition to the high rate of yield upon them, further complicated the situation. Capital values of securities hypothecated as cover for bank indebtedness were not fully responsive to changes in short money rates, so that part of the deterrent effect of a rising rate was lost, because holders had to face little risk of being required to provide additional cover. The result was that until the internal debt had been consolidated by funding, the effects of changes in money rates were partially neutralised. The structure of the debt, when added to the rigidity of wages and other costs, created in this country an economic

situation which could not be controlled by normal monetary methods.

As some improvement in the structure of the debt, without any addition to the interest payable upon it, took place in almost every year after 1919, it is possible to praise the technical skill with which it has been handled by the Treasury. But the existence of a substantial amount of short-term debt, which cannot be funded because of the increased Budget charges involved, causes the same sort of economic disturbance as the maintenance of the money rate of interest below the real rate. There was, therefore, in the whole post-war period, a basic contradiction in British financial policy. Certain measures, such as the limitation imposed upon the issue of Treasury notes and the return to gold at too high a parity, were definitely deflationary in character, but, at the same time, the method of financing the internal debt maintained indirect but important inflationary forces at work. The yield on securities of the highest class was kept lower than was consistent with a policy of thorough deflation, and as these were in much greater supply than they had ever been before, their influence upon the market was considerable. Had a very large part of the debt been funded regardless of cost at, say, 6 per cent in 1920 or 1921, then the condition necessary for a successful re-adoption of the gold standard would have been brought about more rapidly. Orthodox critics who were shocked at the spectacle of Britain leaving the gold standard in 1931 with the Bank rate at 4½ per cent were too late with their strictures. The situation as it then existed was the result of a disharmony between the real and money rates of interest which had persisted ever since the war.

Although between 1923 and 1931 the more simple signs of inflation, such as a rising price-level of commodities at wholesale, or boom conditions in industry, were not present, there were persistent economic disturbances during the period which were inflationary in character. There was a tendency for the cost of living to remain high; there were substantial increases in the volume of employment in the distributive trades without a proportional increase in their output; a too rapid exploitation of new industrial processes; extravagant expenditure on plant and over-capitalisation of industries new and old, and a steadily widening disharmony between sheltered and unsheltered trades. All the new economic developments of the period were superimposed upon a hard core of depression and unemployment in the basic industries.

The whole system was clearly out of balance, and had London not been an international market, able by attracting foreign balances to keep down the Treasury bill rate, the whole structure of money interest rates would have been substantially higher. The debt would have been funded earlier, and at higher rates of interest, and the normal control of the monetary machine over industrial costs would have been more quickly restored. Drastic deflation of the kind that this sort of action would have required would never have been possible, because the international position of London would have made the high rates of interest involved so attractive to external balance holders that a collapse of other European systems would have taken place before it was complete. The fact remains, however, that the degree of economic disorder in the British system before the collapse of the gold standard was much more deep-seated than a mere over-valuation of the

pound at the time of the return to gold in 1925. The intense desire to avoid any further increase in the annual service charge for the internal debt compelled the authorities to try and operate the financial system of the country with a hopelessly unwieldy debt structure. The result was that they were compelled to give hostages to fortune.[1]

How great these hostages were can be seen in the concluding chapters of the Report of the Macmillan Committee on Finance and Industry. It is impossible to read the Report of this Committee without being impressed by the degree to which the minds of its members were influenced by the information which they had obtained with regard to the unbalanced position on short account of the London Market. Chapter III of Part 2 of the Report, with its detailed proposals for internal monetary policy, which involve the re-amalgamation of the Note Issue and the Banking Departments of the Bank of England, seems to be entirely dominated by the urgent need of increasing the liquid resources of London in order to build up a special reserve against these external liabilities. A comparison is drawn between the pre- and post-war conditions of London. "Before the war, London's short-term position with the rest of the world was probably well balanced. To-day her gross liabilities for foreign short-term bills and deposits are largely in excess of her claims in respect of acceptances. . . . London is now practising international deposit banking, as distinct from international acceptance business, and the

[1] It is not suggested that a ruthless policy of deflation *ought* to have been carried out. We chose a practically possible rather than an ideal course of action. It is impossible to say whether the results of the policy actually followed are socially more or less desirable than those which would have accompanied the alternative.

deposits associated with this are on a larger scale than before the war."[1] And the Committee conclude: "We consider that at present the disparity between London's liquid resources and those of other large international centres is too great and should be diminished".[2]

It is significant that this analysis immediately precedes the practical proposals which the Committee made with regard to the reorganisation of the Bank of England which were calculated to permit the Bank's gold stock to fluctuate between £175 million and £100 million, and in addition to permit it to maintain other foreign liquid resources fluctuating in amount up to £50 million.[3]

These figures may have considerable relevance to the scale upon which the Exchange Equalisation Account would appear to have been operating. We shall refer to them below (see pp. 27, 56), but before discussing them it is interesting to analyse, so far as available information enables us to do so, the character of that unbalanced short position of London which clearly caused so much justifiable apprehension in the minds of the members of the Macmillan Committee. They published in an appendix to their Report the figures representing the various forms of short-term liabilities with *per contra* short-term assets at selected dates. Subsequent events suggest that the figures as a measure of the short-term liabilities of London were an under-estimate, while the events of the early summer of 1931 froze a large portion of her short assets. The figures are worth quoting to call attention to changes in their composition.

[1] Cmd. 3897, 1931, para. 439 (iii). [2] *Ibid.* para. 353.
[3] *Ibid.* para. 354.

Table II gives the following series:

Column I. The total in £ million sterling of *deposits* on foreign account in the Bank of England, the Clearing and Scottish Banks, and the Accepting Houses.

Column II. In £ million sterling the *net* short liability of London as given by the Macmillan Committee.

Column III. Expresses Column I as a percentage of Column II.

Column IV. The average three-month bill rate in London.

Column V. The average call-money rate in the New York Market.

TABLE II

| Date | I | II | III | IV | V |
|---|---|---|---|---|---|
| | £ m. | £ m. | % | % | % |
| June 1927 . | 199·3 | 253·1 | 78·7 | 4·07 | 4·2 |
| December 1927 | 206·1 | 279·6 | 73·7 | 4·32 | 3·8 |
| June 1928 . | 228·4 | 278·0 | 85·8 | 3·91 | 5·0 |
| December 1928 | 243·8 | 302·4 | 80·6 | 4·36 | 6·9 |
| June 1929 . | 212·8 | 257·2 | 84·7 | 5·26 | 8·5 |
| December 1929 | 197·5 | 275·4 | 71·7 | 5·56 | 5·6 |
| June 1930 . | 257·9 | 281·2 | 91·7 | 2·32 | 2·3 |
| December 1930 | 246·7 | 273·6 | 90·2 | 2·31 | 2·1 |

The changes in deposits as a percentage of total net short-term liabilities (Column III) are of interest. The figure drops with a rise in the three-month bill rate either absolutely or relatively to short money abroad, and it rises when the bill rate tends to drop. This tendency is shown towards the end of 1927 and early in 1928 when special financial movements connected with German borrowing in New York resulted in

fairly considerable movements of funds into England. The Bank of England was able, during this period, to increase its holding of gold by £17,715,000 between October 1927 and June 1928, and bill rate in London eased in consequence. By June 30th, 1928, balances held in the form of deposits were at a maximum preparatory to the withdrawal of funds during the unusually heavy autumnal drain of that year. Meanwhile, the short rate in New York through 1928 had risen steeply while the London three-month bill rates rose only moderately from 3·91 to 4·36. In 1929 the movements recur on a larger scale. In the first six months, although the magnet of high money rates abroad had reduced total liabilities by approximately 16 per cent, the percentage in the form of deposit liabilities was almost as high as it had been in June 1928. The result was the net loss of £14,347,000 gold in July 1929, followed somewhat tardily by the sharp raising of Bank rate in the autumn, by the New York collapse and by a big return flow of gold totalling £12,035,000 in December. But the most significant result of all was the increase in the total of the short liabilities of London, although the percentage held in the form of deposits declined sharply. But during 1930, as the London bill rate fell to lower levels, external deposit liabilities increased once again to the highest percentage of total liabilities recorded during the period.

These changes in the composition of the short liabilities of London and their relationship to the bill rate in London are significant. It appears that it is not so much the absolute level of money rates but the expected general future movement of bill rate which exercises an important influence upon the character of London's short liabilities. The percentage of deposit

liabilities was high early in 1928, early in 1929, and through the period of "recession" in 1930–31. In each of the early periods there were *prima-facie* strong reasons for expecting rates to rise and a tendency on behalf of foreigners not to hold bills on their own account, but to hold deposits instead, leaving the risk of loss or of temporary illiquidity, which might occur if rates rose during the maturity of the bill, to the financial institutions in London holding foreign deposits.

This tendency to switch from holding sterling bills to holding sterling deposits is precisely what would be expected when the character of the balances held in London is considered. They were partly reserve balances of other monetary systems[1] and partly funds expatriated temporarily either to avoid loss due to local political or economic disturbances, or to enable their owners to use the various facilities for international transfer of funds provided by the London Market. Their proprietors were concerned to keep maximum liquidity and safety at the expense of income obtained. Under such circumstances, it was only natural that the expectation of probable movements of bill rate in the immediate future would have some fairly substantial influence upon the nature of the contract entered into by foreign balance holders with the London Market. They would desire to have bills held on account when technical conditions indicated a fall of bill rate, and *vice versa*. The result of these varying preferences did not have much effect on the general level of bill rates in London, as the demand for bills was practically the same whether the foreigner bought

[1] In 1931, South Africa, Australia, Egypt, India and the Scandinavian countries held balances of this character to a total of £110 million. *Economist*, May 26th, 1934, p. 1145.

and sold them directly on his own account or merely increased or decreased his London deposits. If the London banker did not buy bills on behalf of his clients abroad, he would have to buy them in his own account as an interest-earning asset to cover the net increase in his deposits resulting from the foreign balances. The indigenous banker was in a better position than a foreigner to carry the risk of an adverse movement in short rates, because he could exercise greater choice over the moment at which he disposed of his holding of bills or short-term bonds, since the nature of his business required him to carry a much more complete assortment of local risks than any foreign depositor, private or corporate, could hold.

Thus, prior to the breakdown of the gold standard, there were two problems associated with movements of external balances. Changes in their total magnitude had an important contemporary influence upon the general level of short money rates, while changes or expected changes in bill rate tended to alter the character of external liabilities. This was most dangerous when a high percentage of them were held upon deposit instead of in bills, as the capital value of deposits undergoes no change when Bank rate rises. A sharp rise in Bank rate may push down the immediate value of bills sufficiently to cause their holders to delay realisation until nearer the date of maturity. When a large part of the balances in a money market are held in the form of bills, a sharp rise in Bank rate may delay realisation, and hence reduce immediate pressure upon the exchanges. When a disproportionately large part is held in the form of deposits, then if any doubt about the stability of the exchanges arises, a rise in Bank rate

will be less effective in checking the withdrawal of foreign balances.

The British authorities had had considerable experience of changes in foreign balances even before the gold standard was suspended, and fluctuating exchanges added a new difficulty to their task. In 1932 world-wide depression gave them a great opportunity to fund a large part of the internal debt at low rates of interest. In addition to the relief given to the Budget by conversion, there would also be a real improvement in the technical position of the Money Market. The dependence of the Treasury and the London Money Market upon foreign balance holders could be reduced, and there would be better prospects for the success of a policy of cheap money designed to assist industrial recovery. But the conversion operations could not be expected to be successful unless and until the disturbing influence of movements in foreign balances upon the foreign exchanges, as well as upon bill rates, could be reduced. In the first three months of 1932, London bill rates had fallen as foreign balances returned to London. During this period there had been a very substantial rise in the external value of sterling although both the Treasury and the Bank were buying dollars and francs to repay their New York and Paris credits of the previous year. It was no doubt a matter of satisfaction to the British authorities that they were able to repay these credits without further depreciation in the exchange, but they must also have been aware that they were simply restoring the dangerous situation of the previous year, when the short-dated liabilities of London had proved themselves to be too large for the safety of the pound in view of the shortage of reserves of gold and foreign exchange. They were, in fact, actively

engaged in turning a definite Bank and Treasury liability with a fixed date of maturity into a general sterling liability which the market might be called upon to meet without notice whenever foreign holders of sterling chose to repatriate their balances. The general position was made even more unstable when the pound displayed a marked tendency to rise as soon as it became known that sufficient foreign exchange had been acquired to repay the credits. This showed that there was substantial speculation in the pound and threatened unstable money rates as well as fluctuating exchanges. Some means had to be found to enable the authorities to build up a special reserve to be held against the increasing external liabilities of the market. This was done by the opening of the Exchange Equalisation Account, the organisation of which is examined in the next chapter.

# CHAPTER III

## THE ORGANISATION OF THE EXCHANGE EQUALISATION ACCOUNT

SIMPLICITY and secrecy have characterised the operations of the Exchange Equalisation Account. The first characteristic has aroused misunderstanding, the second suspicion. Secrecy was probably necessary in the early days of the Account when one of its objects was to counter speculation designed to influence the sterling rate of exchange. The possession of power, not necessarily its use, is usually the most effective way of dealing with speculation. After the return to the gold standard in 1925 the knowledge that Great Britain had substantial dollar credits was sufficient to prevent any serious attack on the pound; in 1932 the knowledge that Exchange Account could sell large quantities of sterling if it wished to do so, was an equally effective deterrent against unwanted bull speculation. Much of this deterrent effect would have been wasted if it could have been seen from periodical published statements that the Account was, in fact, only operating on a small scale. There were, as we shall see below, certain book-keeping problems which would have made the publication of such statements difficult, but the decisive factor in the decision to keep the operations of the Account secret was probably a desire not to give gratuitous information to speculators.

Secrecy, therefore, instead of increasing misapprehensions about the purpose of the Account, should, except in the minds of speculators, have allayed them, because it has probably reduced the scale upon which it was necessary for the Account to operate.

The simplicity of the organisation of the Account has also caused considerable misunderstanding. The exact nature of the source from which its funds were derived has been lost sight of, and vague fears have been expressed from time to time that inflation in Great Britain must follow its operations, or that serious losses would fall upon the Treasury as a result of its "speculation with the taxpayers' money in the foreign exchanges". These fears can be set at rest by an examination of the machinery of the Account. It is a small Government Department, supplied with a predetermined amount of Treasury bills which it can sell to acquire sterling. This sterling is then sold to holders of foreign currencies, with the result that the Account has changed part of its assets from Treasury bills into foreign currencies. The rate at which the foreign exchange is acquired is determined by the Account, and by adjusting the rate it can influence the speed at which its Treasury bills are turned into foreign exchange and *vice versa*.

The willingness of foreigners to hold balances in London has an important influence upon Treasury bill rate. The Account, in fact, is simply a device which puts Treasury bills "on tap" for foreigners, and permits them to increase or decrease their holdings of these without unduly influencing the sterling exchange. The method has worked because, since 1932, holders of foreign currencies have wished to increase from time to time their deposit holdings in London, and in con-

sequence Great Britain has been able to raise abroad a short-term loan at very low rates of interest. But since she was borrowing short in this way she found it absolutely necessary to increase her holdings of gold and foreign exchange so that she could, if necessary, repay her borrowings on demand. Because the additional gold and foreign exchange was acquired in this way, steps had to be taken to prevent them being used to increase the supplies of cash in the London money market. It was, therefore, necessary for both the Treasury bills and the gold and foreign exchange to be carried in a separate account.

Given the need of increasing the liquid resources of the London market, it is difficult to see what alternative method of procedure could have been adopted. A formal long-term loan raised by London in foreign centres would certainly not have been subscribed; it was short-term sterling bills and deposits that were in demand. These could have been supplied by the Bank of England itself without the paraphernalia of a separate account if it had been willing to sell Government securities held in the Issue Department and to replace them by gold and devisen. It had already done this on a small scale before the Account came into operation. But this method of handling the business had four difficulties: First, the Bank could not change its holdings of devisen into gold because the market price for the metal at the ruling rates of exchange was far removed from its statutory buying price. Secondly, even if gold had been acquired by the Bank to cover the exchange risk of holding foreign devisen, the result must have been either a fall in the Fiduciary Issue, or an increase in the proportion of the Banking Department which might have been interpreted to foreshadow

a change in internal conditions. Thirdly, the fluctuations in the price of gold would have complicated the Bank's return, and would have given rise to all sorts of complex questions in calculating the distribution of profit as between the Issue and Banking Departments —an important practical point, as the profits of the former go to the Treasury and of the latter to the proprietors of the Bank. Fourthly, it was desired, as we have seen above, to make a substantial gesture to warn off possible speculators. If such a gesture had been made while the Bank was doing the work instead of a separate account, a public announcement would have been necessary that the Bank would hold in the Issue Department, as cover against the Fiduciary Issue, foreign instead of British Government securities to a total of many millions of pounds. Such a publication might have been even more widely misunderstood than the news of the opening of a separate account has been, and in any case the gesture would have lost a great deal of its effect, because the weekly return would have shown the extent to which the Bank was operating.

Another alternative method of procedure would have been to carry out the recommendations of the Macmillan Committee. The Bank of England might have been reorganised by the consolidation of its two departments, the regulations governing note issue might have been changed, and the Bank put into a position to deal in foreign exchange by an increase in its capital which might have been supplied by the Government. No more unsuitable time than the early summer of 1932 could have been found for carrying out so important a change. At a time when the market particularly needed guidance from its Central Bank

on internal policy, the form of the Bank's return would have been completely changed, and to the uncertainties of the period would have been added the difficulty of interpreting the changes in the new weekly statement. The distribution of profit of the newly reorganised Bank would have caused endless difficulties, particularly as it would have been complicated by the unstable exchange and the fluctuating sterling price for gold. There would, moreover, have been no practical way of making a public announcement as to the extent to which the authorities were prepared, if necessary, to sell sterling to counteract speculation. The collapse of the gold standard in September 1931 proved how right the Macmillan Committee had been in insisting that the gold and devisen reserves of the market ought to be increased, and that a method should be found for allowing such an increase to take place without a proportional rise in internal supplies of sterling; but the difficulties arising from the fluctuating exchanges made the actual proposals of the Macmillan Committee for reorganisation impracticable.

The practical solution of these difficulties was found in the device of a separate Account to which had been issued a known maximum of Treasury bills, and which was empowered to buy and sell foreign exchange and sterling at any price it chose. First of all, a gesture was made to warn speculators that the authorities meant business. The number of Treasury bills issued to the Account could be fixed at any figure to which Parliament would agree, because the bills so issued, until they were actually sold in exchange for foreign currencies, represented only the potential and not the actual borrowing of the Account. The figure of £150 million, which was first adopted, should not be taken, therefore, as a

measure of the extent to which the Account actually intended to operate. It only indicated the outside figure to which the authorities might have to go, and were prepared to go, in selling sterling to prevent a too rapid rise in the external value of the pound. The increase in the figure to £350 million in the Budget of 1933 did not necessarily imply any increase in the activities of the Account. It meant that the authorities had found that the tendency to bull sterling had been increased by the difficulties in the United States and in the gold standard countries, and that they were resolved that the increase of foreign balances in London should not be allowed to disturb either the exchanges or the quantity of sterling available for internal purposes.

The separate account, therefore, made it possible to make a substantial gesture against speculation with the minimum of internal disturbance. Secondly, the use of Treasury bills as the means by which the Account could acquire sterling when it wanted to purchase foreign exchange, made it possible to leave the question of the extent to which the foreign reserves of the market should be enlarged to be determined by future increases in foreign balances in London. No arbitrary decision or guess had to be made on this point ; it was settled automatically. As foreign balances increased, there was a greater demand for sterling and for London bills. Both these demands were covered by a sale of bills by the Account and a purchase of foreign currency equal to the increased foreign balances. The adjustments both in the supply of paper and in the holding of foreign exchange were perfectly automatic and cancelled each other out with the minimum disturbance of internal credit conditions.

There were also to be considered book-keeping difficulties that arise from dealing in gold and foreign currencies when the exchanges are unstable. Before the establishment of the Account, the Bank itself had purchased foreign currencies, but it could not turn them into gold because the price of bullion was above its statutory buying price. To permit the Bank to buy gold at any price which it chose would have aroused a crop of complicated accountancy problems, and to change the statutory buying price would have prejudiced the whole question of stabilisation. What was desired was a system by which the authorities could, at will, alter the London import and export points for gold without committing themselves by so doing to any permanent sterling price for gold. By carrying the gold and foreign exchange in a separate account, these book-keeping difficulties were solved. The Account, by altering its buying and selling price for foreign exchange, could alter at will the value of all the external assets which it held and could influence the rate at which foreign balances were either increasing or decreasing. All the complex questions about the distribution of profit or loss, which would have arisen if the Bank of England had been doing the work, were got rid of. The Account was a Government Department and all profits or losses arising out of its dealings fell automatically upon the Treasury.

In this connection, it is worth noticing that there is no substance in the criticism which has been brought against the Account that it may cause large losses to the taxpayers. Some play was made with this in the debate in the House of Commons when the resolution to increase the Treasury bills issued to the Account by £200 million was discussed in 1933. "Augur", in a letter

to *The Times* of May 5th, 1933, argued that "The Fund . . . and therefore the British Taxpayer stood to lose substantial sums if these transactions were continued for a long time". The transactions to which he particularly referred were the sales of gold, which had been purchased by the Account at market prices, to the Bank of England at its statutory buying price. It is said, however, that the Bank actually pays the market price for gold which it purchases from the Account, and only uses the statutory buying price in recording purchases in its balance sheet. But even if it does not do this, any loss arising from this cause, or from any other action of the Account, is only of a book-keeping character, and is completely under the control of the authorities and ultimately of Parliament. Losses can only arise if the ultimate rate of stabilisation for the pound sets up a new statutory price for gold which is lower than the *average* price at which all the transactions of the Account have been carried on since it started operations. That this point was clearly in the minds of the authorities was shown by the statement of the Chancellor of the Exchequer in the House of Commons when he said, during the debate on the 1934 Budget, that, at the price of gold then ruling, the Account showed a profit. This means that more than half the transactions of the Account prior to the date of the Chancellor's speech had been carried out when the price of gold was lower than it was at the time when he made his statement.

The length of time during which the Account operates is irrelevant to the question of profit or loss. The decisive factor will be the ultimate rate of stabilisation. It is in the highest degree unlikely that the pound will be stabilised at a level which will

make the new statutory price for sterling so low as to show losses on the operations of the Account. We have here, incidentally, a guide as to what this ultimate rate of stabilisation will be. It must be above the average of gold prices since the Account began operations, and will probably be fixed so as to show profits and not losses on the Account. The existence of the Account is, therefore, a substantial guarantee that the present sterling price for gold will be permanent. As the gold in the Bank of England will be revalued as well as the assets of the Account, when a new statutory price is decided upon, the Treasury stands to make considerable profits upon the Issue Department of the Bank as well as upon the Account. These profits will, no doubt, be used to write off internal debt, and their use for this purpose encourages the belief that when the pound is ultimately stabilised it will still be possible to keep money rates at relatively low levels.

In addition to solving some of the temporary problems arising out of the disturbed conditions at the time when the Account was set up, the machinery adopted removes certain problems of a more permanent character. The Macmillan Committee, as we have seen above, wished to see the capital of the Bank of England increased and the two existing departments consolidated so that in the future the Bank could hold an increased reserve against the short-term foreign liabilities of the market without disturbing internal credit conditions. The Account enables this to be done without any reorganisation of the Bank or increase in its capital. The cost of carrying these reserves falls upon the Government to the extent to which it has to pay interest to those foreigners who hold Treasury bills, the sale of which enables the Account to buy gold and

devisen. The cost is, however, kept down to the minimum, as increases in foreign balances, and consequently in the interest-earning assets held by the Account, tend to lower Treasury bill rate. No cheaper way of creating a special external reserve could have been devised, and the cost rightly falls upon the Treasury as the reserve is of general advantage to the country as a whole. The question of the future of the Account as part of the permanent machinery of London will be discussed in a later chapter (see pp. 90 *seq.*).

It is clear that the Exchange Equalisation Account lives up to its name. It is essentially an accountancy device to facilitate short-term capital movements and to prevent them disturbing either the exchanges or the supplies of money in the market. It has enabled the British monetary authorities to increase their holding of gold and foreign exchange without committing themselves to any definite rate of stabilisation. This is something of a technical triumph. In normal cases external loans are raised to support a currency which is about to be stabilised. In the case of the pound sterling, however, while a long-term loan was impossible, sufficient short-term loans have been raised as a result of the operations of the Account to improve very substantially the external reserve of the London market. This explains the source from which the funds used by the Account have been derived. They were not created mysteriously from nowhere. They are the proceeds of foreign loans to London which were controlled by the operations of the Account in such a way that they helped, rather than embarrassed, the money market. But the Account could not have carried on its operations without influencing the exchanges. It was free to fix the prices at which it purchased foreign

exchange and gold. Its organisation made it effectively an Account; its policy alone was to determine whether it was to equalise or disturb the exchanges. The effects of its activities upon the exchanges are the subject-matter of the next three chapters.

# CHAPTER IV

## THE CONVERSION OF THE WAR LOAN AND THE FALL OF THE POUND

### I

THE first period of the activities of the Exchange Equalisation Account was dominated by the conversion of the £2000 million 5 per cent War Loan. A very low level of short money rates and some indication that these low rates would persist for a fairly long period of time were necessary for the success of the conversion operations. The increase in foreign balances held in London during the first four or five months of 1932 had pushed down Treasury bill rate, so that by the end of March it was below the low level of the previous year, and in April and May it dropped to below 2 per cent. As bill rate fell, the external value of the pound rose under the influence of foreign buying from its lowest monthly average of \$3·37 to £1 in December 1931 to \$3·73 in April 1932. This rise in the exchanges was accompanied by an increase in "other securities" held in the Issue Department of the Bank of England. These had fallen from their high monthly average of £22·2 million in October 1931 to £6·6 million on February 27th, 1932, and thereafter they rose to very nearly £60 million in May 1932. As "other securities" increased, the "other Government securities" held in the Issue Department decreased, but the effect of these sales of Government securities was offset by the

increased holding of the Banking Department which was about £38 million higher in May 1932 than it had been in the previous year. Bankers' Deposits had also risen considerably, so that internal conditions were easier than they had been for some time. The result was that the yield upon long-term Government securities fell early in May to a very little more than 4 per cent, the lowest level for many years. It appears that the authorities were deliberately encouraging easy monetary conditions with the object of carrying out conversion operations and of assisting industrial recovery. Their problem was to maintain the demand for Government securities in order to keep down money rates; but because the demand for short-term securities was partly due to inward movements of foreign balances, the situation was a delicate one. Further internal expansion based principally upon open-market operations might easily have led to a fear of inflation. Such a fear might have caused foreigners to realise their balances, and withdrawals on a large scale at this time might have rendered the whole policy abortive.

The effects of internal policy upon the relationship of British and foreign prices had also to be considered. The figures suggest that at this time the general situation was in a first condition of equilibrium after the crisis of the previous autumn. The Bank of England published in its Statistical Summary for November 1933 a table giving movements in the indices of prices of primary commodities in the United Kingdom and the United States. British gold prices calculated through the franc exchange are given as well as sterling prices. The primary commodities whose prices are used in constructing these indices are for the most part traded in organised international markets,

and consequently movements in their prices are influenced to a considerable extent by movements in the exchanges themselves; but for examining short-period disturbances, these indices are more informative than those which contain a large number of commodities whose prices are determined largely by internal conditions, and therefore respond to exchange disturbances only after an interval of time. If no change in foreign balances held in London had taken place after the collapse of the gold standard, and if the Bank and the Treasury had not been obliged to buy dollars and francs to repay the credits obtained during the previous summer in New York and Paris, there ought to have been very nearly perfect symmetry between movements in the American Index Number of prices of primary products and the corresponding English Index Number of "gold prices". The Bank of England's table shows, however, that the movements in these indices were not identical. The prices in the two centres move always in the same direction, but week by week the spread between the British Index and the American Index widens from four points in an American Index of 96·0 in the week ended October 10th, to 13·6 points in an American Index of 96·2 in the week ended December 5th. From that date until the second week in May, the spread steadily narrows week by week to a low level of 2·8 points in an American Index of 81·6 on May 14th.

This "spread" between British "gold prices" and American prices of primary products moved conversely with changes in the net interest that could be earned by holding balances in London, with the exchange risk covered by a holding of three-month forward dollars purchased at the same time as the sight sterling was acquired in the form of a London bill. When the

three-month Bank bill rate is adjusted for the premium or discount on forward dollars, the net return on forward-covered London balances fell to 4 per cent at the end of November 1931 and then rose steadily to more than 6 per cent at the end of February 1932. Through March 1932, while sterling was rising, the actual bill rate in London fell slightly below the New York 90-days Bankers' Acceptance rate, but the realisable earnings on holdings of London bills with the exchange risk covered remained high owing to the spread between spot and forward rates. During April 1932 the New York Acceptance rate was falling to very low levels and was being followed down by the realisable earnings on London bills, until the week in which the Budget speech announced the establishment of the Exchange Equalisation Account. Thereafter the actual bill rate in London fell until it was about equal to the New York rate by the end of May. Meanwhile, the realised earnings on sterling holdings with the exchange covered forward tended to move upward owing to the increasing discount on forward dollars.[1]

A comparison of the changes in the "spread" between British "gold" and American prices of primary products and the changes between realisable earnings on a three-months sterling bill with the exchange risk covered shows how delicate the situation was. The "spread" was at a maximum when the realisable earnings were at a minimum, and as the "spread" narrowed until it almost disappeared, the changes in the relationship between the spot and future rates on the dollar sterling exchange caused the realisable earnings in London to rise steadily. The danger of a pound seriously

[1] A chart setting out the movements of the period is to be found in the Statistical Summary of the Bank of England for June 1932, page 3.

over-valued in the early summer of 1932 was no imaginary one, and the tendency for the forward sterling rate to remain low meant that the spot rate was a speculative one and that large balances were held in sterling without being covered forward. In the absence of "speculative" influences, the spread between spot and forward rates in the exchange rate between any two large money centres ought to cancel out such differences as may exist between their money rates. When the premium on the forward dollar is less than that which is necessary to offset a rate of interest higher in London than in New York, there must be a speculative position in spot sterling. The only period after the suspension of the gold standard when the forward dollar was at a sufficient premium to equalise realisable earnings in London and New York was at the end of November and early in December 1931. Thereafter the forward rate tended to go to a discount and the discount increased as the spot rate rose. The size of the discount meant that balances in London must also have risen quite substantially and that the exchange risk involved had not been covered. As the forward contracts matured, some fall in the rate for spot sterling was inevitable, so that the general external value of the pound was extremely unstable. The fall in spot sterling caused by the covering of the unbalanced forward contracts might, if it was allowed to develop unchecked, have caused a second withdrawal of balances from London, and, in consequence, a rise in bill rates there. To prevent disturbances on a large scale occurring, steps had to be taken to fortify confidence in the pound so that balances *bona fide* required in London, and not present there only in anticipation of a further rise in sterling, should not be frightened away.

Unless, therefore, the exchange situation could be brought under control, the prospects of carrying the conversion operations to a successful conclusion could not have been very bright. The external value of the pound was clearly very greatly influenced by movements in foreign balances, and these, in their turn, influenced short money rates in London. The price indices suggest that by the time that the Account was established there was no actual over-valuation; hence, if sterling could be prevented from rising further during the months of May and June, a potential source of trouble could be removed. When it first started its operations, the Exchange Equalisation Account held most of its assets in sterling and so could stop the pound rising even if it could not at that time prevent it falling. But merely to stop any further rise was by itself enough to reduce the danger of a more serious fall in the future. This had an important influence upon bill rates which tended to continue to fall even when the rise in the exchange was stopped by the setting up of the Account.

Moreover, the power to prevent a rise in spot sterling rates was to play an important part in stabilising the exchanges during the later stages of the conversion operations. This point is best dealt with here before we return to the period immediately preceding the announcement of the conversion offer; £2000 million of 5 per cent War Loan was to be converted on December 1st, 1932, and non-converted loan was to be paid off at par on that date. This meant that on September 1st, unless special steps were taken to prevent it, all this War Loan would become the equivalent of a three-months sterling bill bearing interest at a rate of 5 per cent per annum. It would have been a very attractive holding

for foreigners on and after September 1st as they could cover the exchange risk involved by a purchase of three-months forward dollars. In the absence of other influences, this might have meant a big upward movement in the sterling exchange in the early autumn of 1932 followed by an equally rapid fall at the end of the year. Power to prevent this disturbance occurring by exchange control through the Exchange Equalisation Account must have greatly strengthened the authorities in preparing their plans. This factor in the situation also helps to explain why the much criticised bonus of £1 per hundred pounds of stock was paid to those who gave notice of their intentions to convert before the end of July 1932. The effect of this bonus was to give approximately the same profit to holders as that which they could obtain by selling their holdings as soon as they became a three-months maturity. The attractiveness of holding non-assented stock to conversion as a three-months bill practically disappeared. As much could be made by claiming the bonus as by holding non-assented stock to maturity as a bill. The bonus must, therefore, have played an important part in securing the success of the conversion operations. It reduced almost to nothing the supplies of non-assented stock which might have been useful material for exchange operations. It was, therefore, a powerful ally of the Exchange Account in reducing to a minimum the exchange disturbances which would otherwise have been associated with these operations.

Meanwhile, before the actual terms of the conversion were announced, the authorities in London were creating internal conditions designed to suggest that the low level to which money rates had fallen was to be sufficiently lasting to deprive holders of 5 per cent War

Loan of attractive alternative uses for their money in the event of their not being willing to accept the $3\frac{1}{2}$ per cent plus bonus that was to be offered them. We have already referred to the increase in Bankers' Deposits at the Bank of England during May, June and July 1932, the figures rising from £72·3 million in April to £85 million in July. As the note issue was also increased by rather more than £10 million between May and August, the bankers retaining very nearly £7 million of this, there was an increase of bankers' cash from a level of about £174 million in April to over £190 million in August. Advances were falling steeply during these months, so that the bankers were obliged to find employment for their funds by increasing their holdings of bills discounted (from £240 million in April to £374 million in August) and their investments which rose from £287·5 million in May to £363·3 million in August. This increase in the financial demand for bills and securities as a result of the increase in bankers' cash could have been brought about without any operations by the Exchange Account. The Bank, by open market operations, could have increased Bankers' Deposits, and if the Treasury had been willing to sanction it, a further increase in the Fiduciary Issue would have permitted the increase in the note circulation to have taken place. The increase in note circulation between April and August was about £13 million, the increase in the reserve of the Banking Department in the same period was about £6 million, so a further increase of about £20 million in the Fiduciary Issue would have been necessary. Alternatively, the same result could have been achieved by allowing the proportion of the reserve of notes and coin to deposit liabilities of the Banking Department to fall.

Either method of procedure or a combination of both might have had an effect upon general opinion which would have been disadvantageous to the conversion plans. An increase in the Fiduciary Issue can only be made for a limited period of two years upon the authority of the Chancellor of the Exchequer. Any further extension in time requires Parliamentary sanction. There had been already an increase of £15 million which had been continued for nearly one year. If further increases had been made, the need for Parliamentary sanction to continue the first increase would have become necessary in 1933. While it is improbable that Parliamentary sanction would have been refused, the necessity of having to ask for it would have given an appearance of impermanence to the increase, and there was always the danger that any further upward movement in the Fiduciary Issue might have been interpreted both at home and abroad as a sign of impending inflation. Such an interpretation might well have aroused once again fears as to the future of the pound, and we have already seen that there was a large unbalanced forward account against sterling which threatened to disturb the exchanges. The same difficulty would have arisen if the note issue had not been increased, and the "proportion" in the Banking Department had been allowed to fall instead. The movements of the proportion month by month during the period were as follows:

| | |
|---|---|
| April . . | 33·7 per cent |
| May . . | 32·2 ,, |
| June . . | 36·1 ,, |
| July . . | 33·7 ,, |
| August . . | 34·8 ,, |

The figures rise during the time that Bankers' Deposits were being increased, because the existence of the Exchange Equalisation Account made it possible for the Bank to buy gold bullion from the Account and then to increase its cash holding to a greater proportion than its deposit liabilities increased. Its holding of bullion increased by £1·6 million in May, by £10·9 million in June, and there were smaller increases in July and August, the total increase being £17·9 million —from £120·8 million in April to £138·7 million in August. The notes in circulation increased in consequence of this increase in bullion by approximately £12 million and the reserve of notes and coin in the Banking Department by about £6 million. The market's supplies of cash were increased, therefore, not by purchases of securities or by raising the Fiduciary Issue, but by purchases of gold from the Exchange Account. These purchases were made effective by some open market operations, but the movements were similar in character to those which might have occurred if the gold standard had been in operation with the exchange at gold import point.

The result of adopting this method of increasing the supplies of money in the market with the object of keeping down money rates and the yield on gilt-edged securities, was a strong indication to the market that the régime of cheap money was intended to be lasting, and that the authorities were prepared to take the necessary action to keep money rates low. The whole transaction was given a permanence that could not have been associated with a policy which simply increased the Fiduciary Issue or allowed the proportion of the Banking Department to fall below 30 per cent. It may be argued that the authorities ought not to have made

this concession to "gold standard psychology", but as the persons whose "psychology" had to be considered were external holders of sterling balances as well as internal holders of 5 per cent War Loan, it seems probable that the authorities were wise not to go too far ahead of general opinion at this particular time. Had the Exchange Account not been able to buy gold and foreign currencies at market prices and resell such quantities as were needed for internal reasons to the Bank of England, this method of suggesting a long period of low money rates in London could not have been carried out.

## II

We have examined the position as it existed in the summer of 1932, because it gives us some guide in trying to assess the scale upon which the Exchange Equalisation Account conducted its operations in the first few months of its existence. We have seen that there was, when it was set up, a large open position against sterling which threatened the level of bill rate as well as the stability of the exchanges. The Account could do nothing to offset the unbalanced forward position as it had, when it began operations, only very small balances of foreign currencies. It may have taken over approximately £40 million of the "other securities" previously held in the Issue Department. Its other holdings of gold and foreign exchange must have been purchased in exchange for sterling. In May, June, July and August, the sterling exchange on the dollar fell from the high level of 3·75 reached in April to 3·48 in August. Meanwhile, Treasury bill rate fell below 1 per cent in June and reached a low level of 0·55 per cent in September.

The movements in the rate of exchange show that there were net sales of sterling during this period. The Account purchased gold which was resold to the Bank of England, but it did not bring into England greater quantities of bullion than were resold to the Bank, as the net movements through the Customs House in the summer are approximately equal to the increase of gold at the Bank of England. The customs returns from April to August inclusive show a net importation of £25·7 million. This gold is valued at market prices, and when revalued at the statutory price is almost identical with the increase in the gold holding of the Bank. There were also some purchases of foreign currencies by the Bank of England during the period. "Other securities" in the Issue Department rose during July and August and fell again in September, November and December. The movements are not very large, the difference between the highest and lowest monthly average figures being about £17 million. In addition to sales of sterling in connection with these transactions, there was very probably some covering of the position in the forward exchange market, as the opening of the Exchange Account made further speculation for a rise in the pound unattractive.

Throughout the latter part of May and June the gap between American prices of primary products and British "gold prices" widened out from the low level which it had reached, was stable through July, and moved up again to a second high level at the end of September and October. At the same time the position of the forward exchange market was completely changed. The high discount on forward dollars disappeared, tending to bring the realisable earnings upon London balances into line with the money rates of

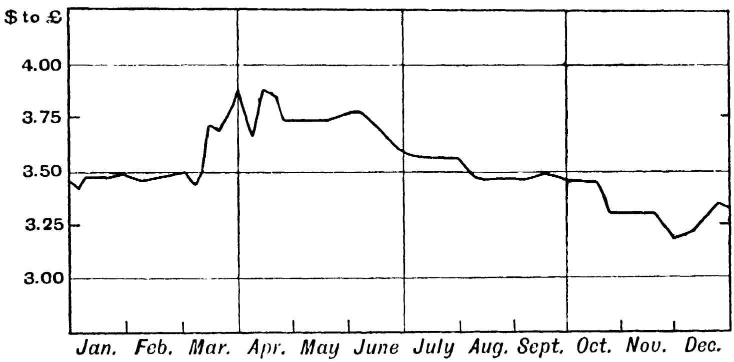
interest in New York. The continued fall in the yield on Treasury bills, however, suggests that there was no substantial realisation of sterling balances by foreigners. It is, of course, possible that the increased holdings of bills and investments by the British banks may have been sufficient to offset any selling of London bills on foreign account, but as the rate fell to very low levels (an average rate of 0·554 per cent in September) it would appear that some foreign demand for bills continued during this period, as when sterling was falling sharply in October and November, at a time when it was known that some foreign balances were being realised, bill rate rose to an average of 0·839 per cent without any substantial change in the holdings of British institutions. External, rather than internal, realisations seem to have moved the rate when it was rising; it seems safe to conclude, therefore, that while it was falling during the summer months, foreign demand was still continuing.

The net increase in foreign balances during June, July and August determines the quantity of foreign currencies and gold which the Exchange Account could have purchased during this period. It could, if it had wanted to do so, have deliberately lowered the external value of sterling by selling into the London market a part of its holdings of Treasury bills to a total in excess of the net inward movement of foreign balances, and sold the sterling so realised, thus forcing down the spot rate of exchange. It is, however, highly unlikely that this policy was adopted. The downward movement in Treasury bill rate shows that the supply of them did not increase as much as the demand, and the authorities must have been reluctant to follow any line of action which, by changing the direction of

movements of short money rates, might spoil the prospects of the conversion operations. It is probable, therefore, that the operations of the Account were upon a relatively small scale.

It would seem that by the beginning of September the Account must have been contemplating the sale, rather than the purchase, of such holdings of foreign currency as it had acquired. The movements of the sterling exchange on New York as a percentage of parity are set out in the following chart:

THE DOLLAR STERLING EXCHANGE, 1932




The slow fall of the pound during the period in which the speculative position was decreased during June and July is clearly shown, and follows the rapid appreciation of three months earlier. The authorities seem to have taken the view that the fairly stable level of the exchanges during the greater part of January and February represented the general equilibrium position, so the flattening out of the curve in August and September when the values of early February were reached probably marks the period in which the pound was pegged against either upward or downward movements. The figures suggest a policy designed to stabilise

the pound at about 70 per cent of its old gold parity. The attempt, if it was made, to hold it at this level failed, and the pound broke sharply in the middle of October and again at the end of November.

## III

These falls in sterling have caused considerable criticism of the British policy in managing the Exchange Equalisation Account. It has been claimed that the British used their power to control the exchanges to manipulate the currencies of other countries, and American criticism in particular has been severe. To answer this criticism the situation which preceded the fall in the exchange must be examined. We have seen that the chart suggests that British policy was probably designed to control the pound at the levels which it had reached in January and February, and that after it had fallen in June and early July it was relatively stable at about \$3·47 to £1 in August, September and early October. It is interesting to notice that during this later period the general economic position was different in two important particulars from what it had been in January and February. In the first place, the relationship between British and French prices had changed to the disadvantage of the pound. The net fall during the intervening months of French prices had slightly exceeded a similar movement in British prices. So far as the United States prices were concerned, the index of primary products had fallen more than the sterling index of similar goods, but the Bureau of Labour's general index number had only fallen 2·2 per cent while the Board of Trade's general index number had fallen by 4·3 per cent. When

allowance is made for the slightly higher average level at which the exchange was stabilised in July and August, it can be seen that there was some slight general weakness in the position of the pound as compared with January and February. If the control was operating, it was probably keeping the pound slightly too high rather than too low at this particular period.

This conclusion is fortified when it is recalled that there had been a substantial increase in the foreign deposits held in London since the previous January and February. It is necessary to try to measure how large the increase was. Some light is thrown on this point by a consideration of the transactions which are known to have taken place and in which sales of sterling must have occurred. As the balance of payments for the whole year was very nearly neutral, these special transactions must have involved a net increase in the foreign deposit liabilities of London. In the first place, the Bank and Treasury repaid their Paris and New York credits to a total of £130 million. Gold previously in the possession of the Bank of England to the value of approximately £15 million, and balances of foreign exchange previously held to the value of about another £15 million, were apparently used for this purpose. The Treasury is supposed also to have had some small reserves which could also have been used. This reduces the total sales of sterling involved in these repayments to about £80 million. But, as we have seen, the Bank increased its holding of "other securities" by about £50 million between February and June, and after that increased its bullion holding by approximately £20 million. All these figures are at the old par of exchange or the statutory price for gold. The increase in "other securities" cannot all have

been for the purpose of repaying the Treasury credits, so it would appear that there was a net additional sale of sterling represented by these transactions of some £50 million, giving a total of £130 million. This figure should be revalued at the exchange rates ruling in the late summer of 1932, and brings the total figure of sterling known to have been sold up to about £180 million.

Some further additions to this total are necessary to allow for the unbalanced purchases of sterling which caused the exchange to rise in February, March and April, but some subtraction is needed for the period during which it declined. A round figure of £200 million is probably not very far wrong as a measure of the extent to which foreign holdings of sterling balances had increased since the beginning of the year. There were, in addition, balances that had not been withdrawn when the gold standard collapsed in the previous summer. The total external short-dated liabilities of London must, therefore, have been very considerable in September and early October 1932, when the authorities seem to have been using the Exchange Account to prevent any further fall in the pound. The Account cannot have had such large holdings of foreign currency and gold as would have been necessary to support sterling at this time. Part of its holdings had been converted into gold and sold to the Bank of England, and could have been made available only by a reversal of the internal policy which we have examined above. The greater part of the foreign currencies acquired in the early part of the year had already been used to repay the Paris and New York credits. All the available information strongly supports the testimony given by Professor O. M. W. Sprague

that at the period when the pound fell there were no resources available to support it.

As soon as the control was obliged, as a result of the exhaustion of its foreign assets, to allow the pound to fall, the movements were sharp and decisive. The fall in the exchange was accompanied by an upward movement of Treasury bill rate and by an increased "spread" between British "gold" and American prices of primary products. The movements were all in the opposite direction to those which occurred while foreign balances in London were increasing. Renewed lack of confidence in sterling and the realisation of foreign balances must be held responsible for the rapid fall in the pound in October as soon as "control" ceased, and again in November when a secondary loss of confidence followed the unsatisfactory debt negotiations with the United States. It is interesting to notice that the pound fell, not gradually as it had done from its high levels of April and May, but in two sharp movements. This suggests that the realisation of sterling balances was upon a small scale, but in the absence of any external demand for sterling, small realisations had a disproportionately large influence upon the rate of exchange. As soon as this fell so low as to cause serious losses to those who were inclined to realise their sterling balances, the movement was stopped and holders preferred to await a more favourable opportunity for realisation. The movement in the exchanges was probably out of all proportion to the movement of balances, but the absence of even a small external reserve left the London authorities powerless to control the situation. They did not use the gold reserves of the Bank of England at this time, as to do so might have increased foreign apprehension. Had this happened, a

larger movement of balances must have followed and the cumulative effects upon the exchanges might have been greater than those which actually occurred. Only after sterling had fallen to new low levels, and when the general movement of balances had ceased, was part of the Bank's gold used to make a special payment to the United States Treasury on capital account of the War Debt.

The rapid fall of the pound in October had a very disturbing effect upon prices and trade. The recovery in prices that had accompanied the greater stability in the exchanges after the decision to set up the Exchange Equalisation Account, gave place to sharp falls in October and November. Not only did American prices fall, but British prices also, in spite of the influence which the lower external value of the pound ought to have had upon them. This secondary fall coming in the autumn season must have been particularly severely felt in the United States, but it is difficult to see how it could have been avoided. Wisdom after the event suggests that a somewhat lower level of sterling in July, August and September might have enabled the Exchange Account to acquire a large quantity of external assets which could have been used to support the pound in October and November. Difficulty, however, was caused by an untimely combination of circumstances, the usual seasonal influences, the completion of the War Loan conversion operations, and the dispute with the United States about War Debts and the great uncertainties arising as a consequence of either a British refusal to pay at all, or an attempt to pay by purchasing dollars in the market. The quantity of foreign deposits in London made the exchanges peculiarly susceptible to emotional forces, and as the

authorities had not had a long enough period in which to acquire the necessary external reserves, the situation rapidly passed beyond their control. This secondary fall in the pound had serious international consequences, and the experience of 1932 emphasises the importance of a strong pound to international trade. London must have an adequate reserve against its external liabilities in order to prevent excessive movements in the sterling exchange disturbing international prices, both paper and gold.

# CHAPTER V

## THE AMERICAN CRISIS AND THE RECOVERY OF THE POUND

### I

THE year 1933 brought with it a new set of difficulties for the managers of the Exchange Equalisation Account. Most of these arose out of the banking crisis in America which paralysed the whole financial system of the United States. There was a flight from the dollar to the pound followed by a series of monetary experiments in the States which weakened the European gold currencies and made the task of monetary management supremely difficult.

As the American crisis developed, there was, in the early months of the year, a steady flight to the pound during which the British authorities supported the dollar by selling sterling and purchasing large quantities of the redundant American gold. But this support was not sufficient; the gold standard in the United States was suspended, and a period of great disturbance followed, during which the gold value of the pound sterling was permitted to fall to below 65 per cent of its old parity. Internal credit conditions did not, however, feel the full effect of this further external devaluation, as bankers' balances at the Bank of England did not increase proportionately, although they were throughout the year at generally higher levels than they had been in 1932.

Before the year opened, the pound had already started to recover from the low levels which it had reached in the late autumn. The realisation of foreign-owned sterling balances stopped, and a strong reverse movement set in. The events of the early spring of 1932 were repeated, with the substantial difference that the Exchange Account was in operation and gave the British authorities at least a passive control over the pound. It was for them a period of very great opportunity. London had been notoriously short of gold and foreign exchange, and in the previous October and November had been unable to prevent a sharp drop in the pound accompanied by international price disturbances, because there were not sufficient reserves available to finance the short-term capital movements of the period. The acquisition of an adequate reserve of gold and foreign exchange was, therefore, a matter of quite first-rate importance if this country was to develop a sound international monetary position. A weak London money market and a falling sterling exchange had twice imposed deflation on other countries. A strong sterling was clearly essential to any permanent recovery, not only in British prices, but in world prices as well, as both these had shown a marked tendency to move in the same general direction except in periods of maximum exchange disturbances.

There can be no question, therefore, that the first duty of the British authorities was to take every possible step to build up an adequate external reserve against the foreign deposits which were in the keeping of London. If they could do this, and remove uncertainty as to the future of the pound, they would at least be paving the way for international recovery and

giving some faint prospect of success to the World Monetary and Economic Conference that was to meet in London. The opportunity to build up the necessary reserve was given by the strong demand that existed for sterling balances. Because the Exchange Account was in being, gold and foreign exchange could be acquired to the extent that foreign balances in London increased. An American economist has tried to trace an arithmetical relationship between the Debt payment made to the United States on December 15th, 1932, and the increase in the gold holding of the Bank of England during the early months of 1933. "In each of the three months (January, February and March) the Bank's gold stock increased by approximately the amount of the December Debt payment."[1] The figures of the Bank's return show an average gold holding of £120·7 million in January and £181·2 in April. During the same period, the Bank's holding of "other securities" in the Issue Department rose from an average of £5 to £12·5 million. If it is desired to exercise flights of the imagination to deduce arithmetical relationships from these figures, the recommendation of the Macmillan Committee that the Bank should hold up to £175 million of gold, in addition to a special foreign reserve of some £50 million, gives as close an identity with the increase in the Bank's gold holding as does the Debt payment calculation.

During this period, the world was preparing for the International Economic and Monetary Conference to be held in London. The British Prime Minister went in April on a pilgrimage to Washington. As subsequent events proved, no progress could be made at the World Conference, because the instability of the international

[1] *American Economic Review*, vol. xxiii. p. 615.

exchanges rendered the whole proceedings futile. Is it too fanciful to suggest that the British authorities used the opportunities that existed in these months, opportunities which were not likely to recur, to smooth out fluctuations in the exchanges in the best possible way, namely by preparing for a *de facto* return to a gold standard? Such a return was impossible without an increase in the liquid assets of the Bank of England. It was unlikely that a foreign loan could be negotiated as part of a conference settlement to make the acquisition of such assets possible. Under these circumstances, the only direct step which the British authorities could take towards the reconstruction of the international monetary system was the building up of the liquid reserve necessary for the orderly management of the short-period external liabilities of the London market. These liabilities were the liquid reserves of foreign balance holders of many different types.

This policy involved a *de facto* stabilisation of the pound in terms of the principal gold currencies, and the selling of sterling which was necessary to maintain this stability made it possible to increase the gold holding of the Bank of England, which rose by £60·5 million sterling, the metal being valued at 85s. per ounce. The net inward movement of gold through the ports during the period February to April was only £38·6 million approximately, but in May the figure was £34·5 million (these figures value the gold at market price). The two biggest weekly net inward movements, £8 and £6·4 million, occur in the weeks immediately following the closing of the American Banks (March 4th) and the suspension of gold payments by the United States (April 24th). The total net inward movement of gold

is roughly equal to the increase in the holding of the Bank of England. This suggests that the quantity of sterling sold during this period was not much greater in value than the gold actually acquired by the Bank; but some allowance must be made for sterling sales, the proceeds of which were held in France, as the London Market was able, at the end of April and early in May, to arrange for a sterling loan to the French Government. These francs acquired by sales of sterling in the early months of the year may have been held in Paris as earmarked gold. The gold holding of the Bank of France was reduced by about £20 million sterling (old parity) between December 1932 and May 1933. The maximum extent to which the Account sold sterling in the early months of 1933 probably does not exceed £100 million in all.

The American charge, in the article already referred to, is that the Exchange Account was able to "beat the speculators at their own game as well as to manipulate at will the currencies of countries with less experience".[1] As the French had had considerable experience in the management of an unstable currency, and had played the game with conspicuous success prior to the *de jure* stabilisation of the franc, the country "with less experience" must be America, and by the same token the speculators "who were beaten at their own game" must be American as well. At this period, there must have been in well-informed American financial circles considerable apprehension as to the future of the dollar. The serious position of the banks was already attracting attention, and the Democrats, traditionally soft money men, were about to come into office.

The extensive dollar demand for sterling, therefore,

[1] *Op. cit.* p. 615.

which enabled London to draw in the gold necessary to improve its technical position, was primarily caused by a flight of American capital, and the existence of the Exchange Equalisation Account served only to enable the British authorities to prevent the influences of the American crisis causing a sharp upward movement in the sterling exchange and a fall in British prices. They were able to acquire sufficient gold and foreign exchange to offset these balances and indeed to face the position in almost the same way as they would have done had the gold standard been operating. In view of the increasing instability in America, it was becoming more and more urgent that London should preserve its international liquidity.

The effect of the withdrawal of gold from America, which resulted from the local bearing of the dollar, need not necessarily have caused any contraction in the United States, as the gold holding of the Federal Reserve System was far in excess of legal minimum requirements. If the internal position had been less unsound the support which London gave to the dollar at this time would have assisted the American authorities by localising the effects of their banking crisis. The gold exported from the United States could have been replaced by Government securities and the resulting demand for Government paper would have operated to keep Bank rate down and so assisted in restoring the liquidity of the banking system. The redistribution of gold which occurred was favourable to world economic conditions generally, as the accumulation of gold stocks in the United States and France, while not so great a causal factor in inducing world depression as is sometimes supposed, is generally recognised as a complicating technical factor.

But just because the situation was dominated by the flight from the dollar, induced by the prostration of the American banking system, it is possible to criticise the operations of the Exchange Account at this period. So long as the United States was on gold, the dollar was linked with, and had a great influence upon, other gold currencies. Nothing that London could have done would have saved America from her crisis. Under these circumstances, therefore, the London authorities might well have had more regard to the position of the other gold standard countries. The support given to the dollar by the sale of sterling kept the pound down in the neighbourhood of 70 per cent of its old parity, not only on the dollar, but also on gold currencies in general. If this was done with the object of increasing as rapidly as possible the cash reserve of London in anticipation of trouble in the United States, the policy was probably a mistaken one. In view of the character of the transactions which enabled the Bank of England to acquire gold, it is highly probable that she would have been able to buy very nearly as much at 75 per cent of parity as she did at 70 per cent; and at the higher rate of exchange the support given to the dollar would have been more effective, as some of the pressure would have been taken off dollar prices while prices in other gold standard countries would also have been considerably relieved from the deflationary influence of the low value of sterling.

External influences, particularly conditions in the United States, probably determined the quantity of sterling which was purchased from abroad at this period, and consequently fixed the maximum for the gold purchases of the British authorities. But the rate at which the gold was purchased was under their con-

trol. They could almost certainly have allowed the pound to rise to somewhat higher levels without reducing materially either the demand for it or their own ability to buy gold. The decision of the authorities to keep the external value of sterling low in the early months of 1933 had such important consequences that we must examine the period in further detail.

## II

In very short periods movements of relative prices do not give much help in determining what the appropriate rate of exchange should be. This is particularly the case when the period to be examined follows one in which prices themselves have recently been upset by movements in the exchanges caused by movements of short-term capital. In the early months of 1933, both the British and the gold price-systems were still under the influence of the secondary deflation which had followed upon the shock to general confidence caused by the break in the pound in October and November 1932. British internal prices, as measured by the Board of Trade's general index number, moved down by 2½ per cent during the first three months of 1933; and gold prices, as measured by a composite wholesale index number including French, Swiss, Dutch, Italian and Belgian prices, fell by about 5 per cent. Irving Fisher's index for the United States, after falling in the first two months of the year, moved upward after the closing of the American Banks. As gold prices were continuing to fall more rapidly than British prices, it would at first sight appear that the British authorities were wise to allow the pound to recover to about 70 per cent of its old parity and then to hold it

there, as it had shown a considerable degree of stability at this level in the previous year. But the prices of primary products, which are more quickly influenced by the exchanges than internal prices, moved during these critical early months of 1933 in a way which suggests that the holding of the pound at the 70 per cent level caused a fresh disequilibrium with gold prices instead of removing a previously existing one. The Bank of England's "sterling index of primary products" showed a distinct tendency to move upward as the external value of the pound rose. In the previous year movements of sterling prices of primary products had tended to go in the opposite direction to the exchange movements, and to follow rather than to precede movements in American prices. In January 1933 this position was reversed.

The Bank of England's index of prices of primary products consists of three groups of commodities—food, metals and other industrial materials. The food index reached its lowest level in the last week of 1932, the metals index in early January 1933 and other industrial materials, principally cotton, hides, linseed, rubber and wool, continued to move down until the American banking crisis early in March. The general British index reached its lowest point in terms of gold in the last week of 1932, and in sterling in the first week of 1933, and then rose about 3 per cent before the beginning of March. Meanwhile the sterling exchange on the dollar had recovered from the low average of 3·276 in December to 3·360 in January and 3·422 in February. The rising exchange accompanied by a rising and not by a falling index of prices of primary products was a new phenomenon since the gold standard had been suspended. British demand

for primary products had recovered, and prices even of imported products moved against the exchanges. The movement would probably not have been checked by a slightly higher external value of sterling, and had the pound been allowed to rise pressure on European and American gold prices would have been less severe, and the British recovery might have been communicated to these areas to the advantage of international trade in general. The evidence is very scanty, and it is very difficult to say with any certainty what would have happened if the pound had been allowed to appreciate to about 75 per cent of its old parity with the dollar at approximately 3·75 and the franc at about 94 to £1. But there do seem to be some grounds for thinking that a less cautious policy on the part of the British authorities at this time might have reduced the disturbances of the latter part of the year. An earlier rise in gold prices would have been of material assistance to France and Holland, and might have made the American difficulties less severe. Nothing which London could have done would have prevented the American banking crisis, but an early reversal of the trend of gold prices might have isolated its influence.

If the gold countries had been helped in this way earlier in the year, the gold hoarding which characterised its later months might have been on a smaller scale. We have suggested that the pound was kept low because it was thought to be desirable to increase the cash resources of the London market. Had it been allowed to rise to 75 per cent of its dollar parity instead of being retained at 70 per cent it is probable that there would have been little or no net effect. The British authorities might, in the first three months of the year,

have purchased rather less of the newly mined gold sold in the London market, but after the suspension of the gold standard in America, they had to compete for this gold against a hoarding demand on foreign account. The intensity of this demand was in part due to apprehension as to the future of gold currencies in view of the strain that had been imposed upon them by the low value at which the pound had been held and to which the dollar was falling. A more moderate acquisition of quick assets in this early period might, taking the year 1933 as a whole, have resulted in the same total acquisition of assets at lower sterling prices and upon a more stable basis. An examination of the gold movements during the rest of the year 1933 is, therefore, necessary. These movements and those of the whole period since the beginning of 1931 are set out in the following table, which is based principally upon the figures given in the Statistical Summary of the Bank of England for February 1934, and illustrates the changes in the monetary reserves of the selected groups of Central Banks measured in millions of pounds.

The increase in the European gold group between March 1931 and December 1932 is £375 million gold. Meanwhile, Germany, the United Kingdom and the United States lost £160 million. The new gold production of the world during 1931 and 1932 was valued at £197·3 million gold, and the gold value of the arrivals in England of Indian gold was £37·6 million in 1932. The net increase of £375 million in the gold standard group was rather less than the losses of the other countries plus the new production and Indian arrivals which together reached a total of £395·9 million. The gold reserves of the fifty-four countries of the world as a whole increased during 1932 by about £275 million.

TABLE III

Gold Reserves of Leading Countries
(In millions of £ sterling at 85s. per fine ounce)

| | 1931 | | | | 1932 | | | | 1933 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Gold Group | Mar. | June | Sept. | Dec. | Mar. | June. | Sept. | Dec. | Mar. | June | Sept. | Dec. |
| Belgium . | 41 | 41 | 71 | 73 | 72 | 73 | 74 | 74 | 76 | 76 | 77 | 78 |
| France . | 452 | 454 | 478 | 553 | 618 | 661 | 666 | 668 | 647 | 654 | 661 | 621 |
| Italy . | 57 | 58 | 59 | 61 | 61 | 61 | 62 | 63 | 68 | 73 | 76 | 77 |
| Netherlands | 37 | 41 | 58 | 73 | 73 | 81 | 85 | 85 | 78 | 63 | 72 | 76 |
| Switzerland | 26 | 33 | 67 | 93 | 97 | 104 | 105 | 98 | 100 | 74 | 73 | 79 |
| Total . | 613 | 627 | 733 | 853 | 921 | 980 | 992 | 988 | 969 | 940 | 959 | 931 |
| U.S.A. . | 893 | 944 | 897 | 833 | 819 | 712 | 770 | 813 | 805 | 821 | 824 | 824 |
| United Kingdom | 144 | 163 | 135 | 121 | 121 | 136 | 139 | 120 | 173 | 191 | 192 | 192 |

As the holdings of the five countries at the top of the table increased by £375 million, they had substantially improved their position *vis-à-vis* the rest of the world.

The impact of British gold purchases in the first three months of 1933 came, therefore, upon a gold group which had already largely increased its gold holdings in both 1931 and 1932. The group gained £226 million between June and December 1931, while London, New York and Germany lost £273 million. They continued to gain gold during 1932, the newly mined, or newly available gold totalling some £140 million against an increased gold holding by the group of £135 million. During the period of acquisition of gold by the Bank of England in the early months of 1933, the group lost £44 million, while the Bank of England gained £71 million, the United States lost only £10 million, and Germany surrendered £30 million.

The subsequent movements during the year are more difficult to unravel. The Customs House figures suggest that the gold in Great Britain increased during the whole year by £133 million approximately, at standard prices.[1] Of this total £72 million approximately is known to have gone into the Bank of England. The *Economist* suggests that about half this gold was already held in the United Kingdom before the beginning of the year. It is difficult to substantiate this suggestion from the figures for gold movements in 1932. The net movements into the United Kingdom from January to August inclusive total £25·7 million at market price, approximately equal to the increase at the standard price of nearly £20 million in the gold held by the Bank of England during this period. Between August and September, the autumn returns showed a net outward movement of £2·3 million, followed by a further net outward movement of £13·8 million in January 1933. Thus, unless substantial balances of gold were already being held in the United Kingdom on foreign account prior to the beginning of the year 1932, it seems difficult to explain the presence in this country of so large a sum as £36 million at standard price which could be transferred to the Bank of England early in 1933. If we have to subtract the whole of the £72 million acquired by the Bank of England from the net increase of gold in Great Britain of £133 million, we are left with a balance of only £61 million to account for. This figure is, however, too low, because the decrease in the gold holding of the Bank of England, caused by the payment made to the United States on account of War Debt, appears in the Bank returns for the last two weeks of December 1932.

[1] See *Economist, Review of 1933*, p. 10.

But part of this gold was not actually passed through the Customs Houses until the early days of January 1933. To allow for this time lag, we must subtract about £20 million from the increase in the gold holding of the Bank, making the figure £52 million instead of £72 millions. This makes the increase of gold in London, other than that in the Bank of England, £80 instead of £60 million. The increase in the world's supply of gold during the year, including bullion released from India as well as newly mined metal, was £126·2 million. Of this £80 million were hoarded in London; the Central Banks of the world, including the Bank of England, increased their holdings by £4 million net, leaving £42 million available for industrial purposes and for hoarding outside Great Britain. The demand for hoards which were held both in London and elsewhere was a more important factor in determining the distribution of the available gold than the increase in the reserve at the Bank of England. But hoarding was the result of the pressure on the gold standard currencies caused by the low level at which the pound sterling was controlled. The rate of exchange at which the gold was bought by the British authorities was, therefore, more important than the size of their purchases.

The impact of the increase in the gold holding of the Bank of England and of idle gold in the United Kingdom took the form of a reduction in the monetary gold reserves of the gold bloc of £77 million between December 1932 and December 1933, but of the total £40 million were lost by the Bank of France during September and December 1933, during the period of political instability. The figures of net imports of bullion into the United Kingdom during the period suggest that

much of it was sent to London for hoarding and for subsequent resale to the United States. The losses of the gold group during the period should be seen in perspective against the increase in gold of £240 million (approximately 40 per cent) between March and December 1931, and of £67 million in the same period of 1932. The acquisition of gold by the British authorities, even if we suppose that the whole of the increased visible supplies of the metal in this country during the year belong either to the Bank of England or to the Exchange Equalisation Account, and leave nothing for gold hoarded in London on foreign account, cannot of itself be written down as imposing deflation upon the gold standard countries. The reduction in their monetary reserves of gold was not upon a sufficient scale to offset the previous increases in 1931 and 1932, and the group as a whole held in December 1933 gold monetary reserves approximately 50 per cent higher than those held in March 1931. The gold held by the Bank of England increased during the period in approximately the same proportion.

The events of the year as a whole show that there was a desirable distribution of gold and that part of the effects of the movements of short balances in 1931 had been removed. The scale upon which hoarding was practised, however, introduced a new element of uncertainty into international monetary relationships, and seems, in part at least, to have been caused by the pressure that was imposed upon gold standard countries by the low level at which the pound had been maintained. In this way some of the benefits of the improved reserve position in London were lost and national and international depression was prolonged. Had more regard been paid to the movements of gold

prices, some of these difficulties might have been avoided. The relationship between British and gold prices is at least as important as the technical position of the London money market. In the next chapter these price relationships are examined.

# CHAPTER VI

## BRITISH AND GOLD PRICES AND THE STERLING EXCHANGE

IN previous chapters reference has been made from time to time to the movements of prices in Great Britain and elsewhere, and their relationship to movements in the exchanges. This chapter reviews the period as a whole with the object of disclosing the long-run effects of the management of sterling which has been practised since the crisis of September 1931. It has been claimed on behalf of the Exchange Equalisation Account that it has not sought to influence the fundamental factors determining the external value of the pound, but has only tried to reduce the size of the fluctuations round the "natural" rate. We have examined some of these fluctuations in previous chapters and have seen that the Account has in practice been able to reduce them. It remains to be asked whether it has been possible to carry out these operations without influencing the long-term movements of the exchanges. We can only answer this question by re-examining the movements of the rates of exchange and of prices during the whole period since September 1931.

Unfortunately the last three years are particularly baffling to any attempt to call in statistical aid in examining the inter-relationship of changes in prices and costs and the foreign exchanges. Artificial interference

with the whole process of trade and industry has been so severe that the isolation of any one factor from the general confusion is wellnigh impossible. And, in addition to this, there is no agreed period of recognised "equilibrium" which can be used as a starting-point and as a base for the necessary statistical series. To go back to pre-war days is out of the question; the changes in "other things" make any reliance upon data originating then valueless, and while it is generally agreed that Great Britain returned to gold at a parity which over-valued sterling, attempts to express the degree of disequilibrium which existed at that time served only to arouse controversy between Professor T. E. Gregory and Mr. J. M. Keynes, each of whose views seemed to depend upon the particular series of figures used to measure it.[1]

Even if it is agreed that we were in disequilibrium in April 1925, it is practically impossible to measure with any degree of accuracy the extent to which the developments in Great Britain and the United States respectively in subsequent years resolved the disequilibrium. Had we come into equilibrium in 1928, and if so, did the extreme fluctuations in the United States between 1928 and 1931 destroy the equilibrium? If they did so, in what direction did they operate? Were we driven off gold in 1931 only because of the technically unstable position of London, or had that position resulted from retaining through the whole period since 1925 the high cost and income structure which made sterling over-valued at 4·866 when we returned to gold? Or had a new disequilibrium developed owing to the relative rigidity of our costs during the earlier period of the depression following the Stock Exchange crash

[1] See T. E. Gregory, *The First Year of the Gold Standard*, pp. 50 *seq.*

of late 1929? And even if all these questions are answered, we still have to consider the complex problems of the relationships between the pound and the franc and other gold currencies before and after the departure from gold in 1931.

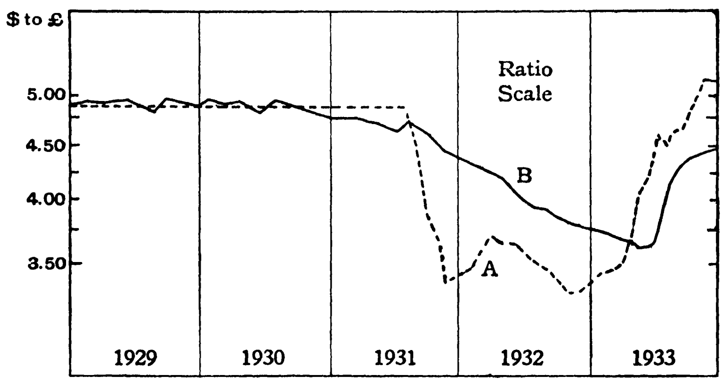
In the face of difficulties and perplexities on so stupendous a scale, the attempt made below to gauge statistically the movements of sterling since September 1931 is submitted with the greatest possible reserve. No reliance is placed upon any one of the statistical series examined, but cumulatively they do throw a certain amount of light upon these extremely controversial questions. The first problem, however, is to examine the whole period between 1924 and 1931 with the object of trying to find a base period upon which to work. Indices of prices are of no great value here. Prices at wholesale were dominated by the equilibrium which existed in the exchanges, and they must, so long as the gold standard operated, have come into harmony even if the underlying economic structures were out of adjustment. Indices of cost of living are not of much greater value as they are likely to have been influenced by changes in internal conditions which need not necessarily have destroyed equilibrium. Indices of wages are subject to the same objection. But even if the relative levels of such series of comparable indices are not informative, the degree of numerical variation in the ratios between them may be of some guidance in this first problem of discovering when something approaching stable economic relations existed between the various systems. If we take, therefore, indices of English and American costs of living, money wages and efficiency wages, we find that their respective ratios fluctuate widely through the period 1925–31, but that

these fluctuations are upon a relatively small scale—about 2 per cent—in the last nine months of 1927 and the first six months of 1928. The ratio of money rates of wages gives movements upon a similarly small scale, particularly if the trend be removed. These statistical tests lead to the conclusion that there was something approaching a working equilibrium, although it proved to be a very unstable one, between the United Kingdom and the United States during the period June 1927 to June 1928. We use this period as a base for the examination of subsequent developments.

Prior to the abandonment of the gold standard, the price indices are ignored, and the movements of relative costs are examined by means of a comparison of British wages (Bowley's index number) and American wages (National Industrial Conference Board index number). The ratio between the two shows a clearly defined trend through the whole period which is removed. Once this is done, this index, which has a time lag which has not been removed, shows that from the middle of 1930 sterling was cumulatively over-valued (see Chart I), and that by the date of departure from gold the rate of exchange should have been about 4·55 to £ sterling. After September 1931 the downward movement continues, but sterling was henceforward substantially under-valued, especially in the periods of the repayment of the foreign credits in November-February 1931–2 and during the "flutter" caused by the war debts discussion at the end of 1932. The curve tends to flatten out at this period and remains at a level which suggests a parity rate of 3·75 at the end of 1932, and early in 1933. It sinks again in the final stages of the banking crisis of the United States and rushes upwards as the dollar fell after the

opening of President Roosevelt's "Recovery" programme. The removal of the trend from the ratio of the indices of rates of money earnings makes it approximate to an index of relative efficiency earnings, so that it reflects the rapid pace of industrial development in the United States prior to the crash of 1929 as well as the greater elasticity of American in compari-

CHART I

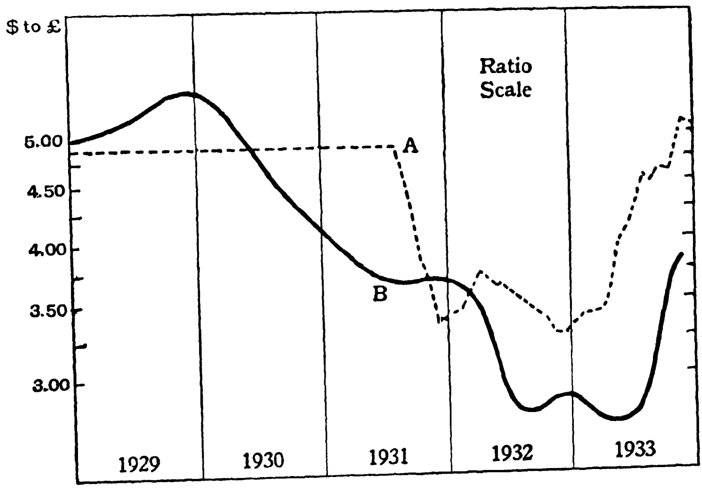



A. *$-£ Exchange*
B. *Ratio of American to British rates of wages*

son with British costs in the subsequent depression. Further to demonstrate this point and to examine the probable size of the time lag inherent in the wages data, an attempt has been made to construct crude indices of "efficiency wages" for the United States and Great Britain respectively. For the United States the National Industrial Conference Board's Index of Payrolls was divided by the Federal Reserve Board's Index of Production, and for Great Britain Professor Bowley's Wage Index was multiplied by an index of British insured population in employment and divided by the British Index of Production. The ratio between the two resulting indices is shown in Chart II. Con-

spicuous seasonal variations have been removed, and other irregularities have been smoothed out of the curve. The base employed for determining the locus of the ratios in relationship to that of the course of the exchange rate is such as to make the average of June 1927-June 1928 in equilibrium with the old gold par of exchange.

CHART II

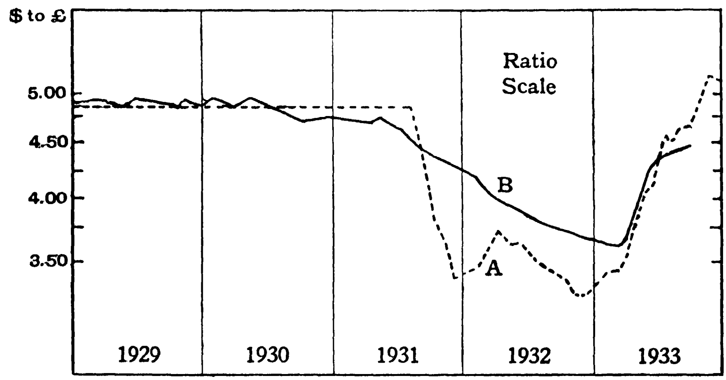



A. $-£ *Exchange*
B. *Ratio of American to British efficiency wages*

It will be seen that this ratio exaggerates the magnitude of all the known movements since 1928: for example, the over-valuation of the dollar in the last stages of the stock-market boom and the over-valuation of the pound when American costs proved to be more elastic than the British in the depression following the crash. The chart clearly exaggerates the vertical movements, but it is more sensitive in time than the wages ratio used in Chart I. The changes in the direction of the curve in Chart II precede those of

Chart I by about three months. In order, therefore, to use the data in Chart I to measure the probable degree of over-valuation of the pound immediately prior to the breakdown of the gold standard, a time lag of three months has been removed from the wages ratio and the result plotted against the market rates of exchange between the pound and the dollar in Chart III. The result of making this adjustment is to

CHART III



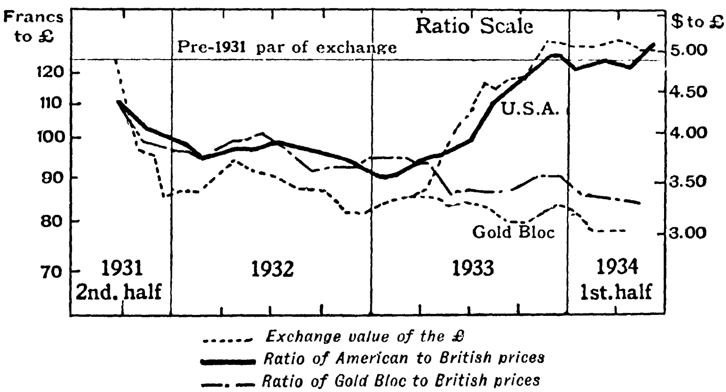

A. *$ - £ Exchange*
B. *Ratio of American to British rates of wages, moved three months to the left (i.e. shown three months early)*

show an over-valuation of sterling of approximately 10 per cent in September 1931, so that the equilibrium rate of exchange at that time was approximately \$4·40 to £1 instead of the market rate of \$4·84.

This long examination of the position existing in September 1931 has been necessary to enable us to use prices data in examining the course of the sterling exchange since the suspension of the gold standard. Purchasing power parities between the pound and the dollar and principal gold standard currencies have been calculated by using the *Economist* Complete Index

for British Prices; Professor Irving Fisher's index number for the United States and a composite index of French, Dutch, Belgian, Swiss and Italian prices for the gold standard currencies. The data used have been adjusted to allow for a 10 per cent over-valuation of the pound early in September 1931, but after May 1933 the adjustment has been removed from the American data to correct the influence upon American

CHART IV




costs of the various "recovery" measures taken in that country.[1]

Chart IV plots the changes in the two "purchasing power parities" and shows their relationship to the ruling rates of exchange. The chart shows fairly considerable uniformity of movement between the "parity" and market rates of exchange, particularly in 1932. In the early months of that year, before the Exchange Account was opened, the market rate persistently approached the equilibrium rate, and again in the late

[1] This adjustment seems *prima facie* to be reasonable in circumstances under which prices were subject to indirect and costs to direct influences.

summer of that year when the Account was supporting sterling by offsetting withdrawals of foreign balances, there was some tendency towards equilibrium. The apprehension caused late in 1932 by the war debts dispute increased the under-valuation of the pound, but early in 1933 the tendency towards equilibrium reappeared. Indeed, had the pound been allowed, late in January and early in February, to rise to the level at which it had been supported in the early autumn of 1932, there would have been very close harmony between the price structures of Great Britain and the gold standard countries.

On each occasion that the external value of the pound has dropped, the gap between the market and parity rates has widened. The first large drop since the opening of the Exchange Account occurred in the autumn of 1932, and as we have already seen (page 50) almost certainly could not have been prevented. The further devaluation of the pound in terms of gold, first during the period of American gold "re-pricing" experiments in the autumn of 1933 and then after the return of the dollar to gold in 1934, almost certainly could have been prevented, and in fact would have been prevented had the Account been managed solely with the object of offsetting short-term fluctuations without disturbing long-term movements.

It appears that about the end of 1932, the initiative in international monetary affairs passed definitely to Great Britain, with the result that a neutral[1] monetary policy was no longer possible. We have argued in Chapter V that if the external value of the pound had been allowed to rise a little higher early in 1933 pressure would have been taken off gold prices to the great

[1] "Neutral," in the sense of allowing the pound to find its own level.

benefit of European conditions and with no apparent disadvantage to Great Britain and sterling countries. The fact that sterling did not rise sufficiently to bring about this very desirable result suggests that the Account was purchasing more gold and foreign exchange than was absolutely necessary to offset short capital movements into London. The very large increase of gold in Great Britain during 1933 and the ability of London to arrange for a short-term loan to the French Government in the early summer of 1933 show how excessive the sales of sterling had been. At this time, the Account appears to have been exercising a positive policy with regard to the external value of sterling. Again in February 1934, immediately after the revaluation of the dollar, the gold value of the pound dropped downward, showing once again that either consciously or unconsciously the control was operating not to offset movements of balances but to determine the external value of the pound. Indeed, since April 1933, the whole policy of the Exchange Account seems to have been changed. The pound becomes a satellite of the dollar as the result of the deliberate choice of the Exchange Account, and the gold currencies are allowed to appreciate in terms of sterling to the level necessary to equate the dollar and the pound.

This important change in the way in which the Account was managed has passed almost unnoticed. Official utterances have still declared the policy to be limited to smoothing out fluctuations in the exchanges, but it is clear that since America left gold this policy has been abandoned unless the authorities mean by "the exchanges" the dollar-sterling exchange only. The policy of following the dollar has probably been a mistaken one. The character of the recovery measures

taken in the United States was calculated to reduce the competitive position of the United States internationally. There was really very little for Britain to fear from a dollar temporarily under-valued as it would have been with a rate of exchange of, for example, \$5·50 to £1. But a higher value for the pound on gold currencies would have eased the European position substantially and would probably have prevented that further fall in gold bloc prices which has taken place during the first five months of 1934 while the franc exchange on London fell from 83·25 to 76·50.

By midsummer 1934, however, the rise in American prices has practically removed the under-valuation of the dollar; gold bloc prices seem to be coming into equilibrium with sterling prices, and the exchanges appeared to be stabilising in the neighbourhood of 76·50 francs to £1 and the dollar slightly over \$5·00 to £1. After the first steps in following the dollar had been taken immediately after the January stabilisation, the pound was supported when balances were returning to France, and the Account was carrying out its proper functions of offsetting movements of short-term capital. Its adventures in the regions of higher policy have, however, had important results and have caused a further piling up of gold in London, the increase shown by the Customs returns for the first six months of 1934 being more than £97 million at market prices. Had the pound been kept at higher levels in terms of gold during the first six months of the year, further gold hoarding might have been avoided and the shocks to international confidence which have been caused by economic experiments in the United States and political difficulties on the continent of Europe might well have been reduced. The American situation

made a purely automatic policy, designed to reduce short-term fluctuations while the pound found its "natural" level, inadequate. Any decision taken by the managers of the Account to buy or sell sterling was in itself an important factor in determining what the long-term rate ultimately would be.

Quite apart, however, from the wisdom of the policy actually followed by the Account during the period of the American experiments, there remains the question of whether it is desirable that the determination of matters of such high policy as the external value of the pound, and therefore the economic relations between Great Britain and the rest of the world, should be settled by an anonymous and secret body whose actions are not open to continuous scrutiny and criticism. So long as a more or less routine policy of offsetting movements of foreign balances while the pound was finding its new equilibrium level was the sole function of the Account, it was necessary that its operations should be covered with secrecy. But as soon as the difficulties that had to be faced arose, not from the unstable character of sterling itself, but from disturbances in other important currencies, there was at once a danger that routine management would break down, and that the authorities would find themselves confronted by a dilemma: the divergence between the quantitative and qualitative sides of their problem. Their duty is stated to be the reduction of fluctuations and disturbances in the exchanges. This may be interpreted to mean reducing to a minimum the variations in the market prices quoted for an important currency such as the dollar, or it may, and should, mean the maintenance of proper relations between the prices in this country and those of a large part of the rest of the world. If the currency

which is moving erratically is so important a monetary instrument as the dollar, the Exchange authority, in the absence of any other criterion, may well conceive its duty to be to reduce the fluctuations between the pound and the dollar if it can do this by permitting steady movements in the sterling rates of exchange on other currencies. From a superficial point of view, this will appear to be the appropriate policy for a body charged with the duty of reducing fluctuations in the exchanges. The difficulty is that economic disturbances of a far-reaching kind may be set up if the objective sought is a reduction in the numerical fluctuations in a group of exchanges when some are approximately stable and others are undergoing violent change.

We reach here the heart of the whole problem of exchange management. In the short period, for the maintenance of continuity in financial and commercial transactions, it is clearly desirable that the limits of variations in market quotations should be the criterion observed by the managing authority. But for the maintenance of economic inter-relationships of a more fundamental character, wider variations in market fluctuations may be appropriate. The principle underlying the Exchange Equalisation Account is, therefore, inadequate. It is relevant only to a very limited set of conditions, and attempts to apply it under circumstances such as those created by the fluctuations in the dollar must be dangerous. The Account provides no permanent way of escape from the old conflict between stable exchanges and stable prices as the *quaesita* of monetary policy. The limited objective of reducing fluctuations can only be successfully attained when the currency under management is the only important currency which is unstable.

We can now answer the question with which this chapter began: has the Exchange Equalisation Account been able to follow its avowed policy of reducing short-period fluctuations in the pound without disturbing the long-term movements, or has the management necessary to minimise short-period fluctuations itself set up disturbances in the long-term rate? Prior to the collapse of the dollar, it seems that the management of sterling was generally successful in bringing the external value of the pound into something approaching equilibrium with a minimum of short-period fluctuations, but as soon as the dollar became unstable the attempt to maintain order in the day-to-day movements of the exchanges resulted in important influences being put upon the long-term rate. The managers of the Account thought it their duty to minimise movements in the exchanges although by so doing they actually increased the disturbances in price relationships. This criticism does not in any way condemn the management of the Account, but it means that there are definite limits to its usefulness. It is an effective piece of machinery for handling short-term capital movements, but it cannot be used successfully even for this purpose when major questions of policy remain undetermined. In the next two chapters we examine ways in which the equipment of the London money market may be improved by incorporating the Exchange Equalisation Account in the Bank of England.

# CHAPTER VII

## THE FUTURE OF THE EXCHANGE EQUALISATION ACCOUNT

THE operations of the Exchange Equalisation Account and the part which it has played in solving some of the problems which have confronted the London market since the war, raise some interesting general questions which have considerable importance for future monetary policy. We have already referred to the recommendations of the Macmillan Committee with regard to the structure of the Bank of England (p. 15), recommendations which were based upon its observations that "London is now practising international deposit banking as distinct from international acceptance business". This practice, although it may be upon a more manageable scale in the future than it has been in the past, has clearly come to stay, and should be encouraged as it is a feature of increasing international interdependence. It calls, however, for a reconsideration of financial practices and even for a restatement of some of the rules for operating an international gold standard.

The Macmillan Committee's recommendation that the Issue and Banking Departments of the Bank of England shall be amalgamated, and that there shall in the future be less direct interdependence between the gold held by the Bank and its note issue, is a first

step in the development of a new gold standard technique. Gold is to be regarded as an asset held primarily against external liabilities, and not as the direct regulator of the internal credit structure. The establishment of the Exchange Equalisation Account put this doctrine into practice. The Account purchases the gold and foreign exchange which are needed to offset the external liabilities of London. It is able, at the same time, to arrange for the transfer to the Bank of England of such quantities of gold as are required under the existing regulations governing the note issue to enable the Bank to follow the internal credit policy which it desires to adopt. Here is an experiment in monetary management which is of quite first-rate importance. It raises questions of theory and practice which we must examine. These questions have a direct bearing upon the general principle enunciated by the Macmillan Committee and are of great significance for future monetary policy both in London and elsewhere.

We must begin with an examination of the differences between international acceptance business and international deposit banking. The former tends to be self-liquidating in character and to establish a rough identity between the external credits and debits of the market on any particular occasion, provided that the basic economic factors influencing the total balance of payments are in approximate equilibrium. A British house accepts and floats into the London money market a foreign bill with a maturity of, say, three months[1]; the drawer of the bill sells the sterling placed at his disposal by the market and this tends initially to

[1] In the case of documentary credits which cannot be marketed, these steps would not be taken, but there would be a potential instead of an actual weakening of sterling which would persist until the credit was closed.

weaken sterling. At the same time, however, and to a slightly greater extent as a result of the discount and commission charges, sterling is strengthened, because before the date of maturity of the bill the drawee has to acquire funds to meet his London obligation. There is, therefore, a continuous buying and selling of sterling by foreigners, and except when there is a change in the volume of business being done, these payments offset each other with a slight cumulative tendency in favour of the pound. The timing of the various transactions is the important factor in the situation: sterling is first weakened and then strengthened. Disturbances that arise due to changes in the volume of business can normally be controlled by the ordinary mechanism of the Bank rate before they reach dangerous proportions. If the volume of business is tending to increase too rapidly, a rise in Bank rate will reduce the demand for discount facilities in London and will relieve the immediate pressure upon sterling arising from the sale of the proceeds of bills discounted. It will probably at the same time make the holding of balances in London more attractive to foreigners, so that net sales of sterling may be readily changed into net purchases of sterling. Conversely, a reduction in Bank rate will tend to weaken sterling, as more bills will be discounted in London, but the pound will not be unduly weakened on this account, as foreigners who wish to use discounting facilities in London must hold deposit margins proportional to the volume of business being carried out on their behalf.

Thus, while international acceptance business was the characteristic activity of the London market, movements of money rates did not, under normal conditions, cause any major displacement of funds. The timing of

the payments to and from London was altered, and this alteration in the timing was sufficiently under the control of the Central Bank to enable it to use its powers to alter its bullion holding to meet the requirements of the internal situation. The impact of changes in the money-rate structure was felt internationally, small movements of bullion were associated with them, but cash displacements on a grand scale did not normally occur.

The position is entirely different when the market is practising international deposit banking as its characteristic activity, and the difference is accentuated when a large part of the international deposits in London are liable to move as the result of political and psychological, rather than strictly economic causes. In the first place, the timing of the transactions is different. There is first a demand for sterling when a deposit in London is acquired by the foreigner, and this demand strengthens sterling; but there is a corresponding liability as the foreign deposit may be withdrawn at any time at the will of its holder. It is, therefore, much more difficult to pair off the purchases and sales of sterling which occur in connection with the movements of these deposits. The whole position turns upon the policy adopted when the foreign deposits are *entering* the market. Strictly speaking, the Central authority should, at this stage, acquire gold or foreign exchange in sufficient quantities to balance the inward movement of foreign balances. If it does this, the position is secure, and the future withdrawal of foreign-owned balances has been provided for; the whole proceedings become parallel to those which occur when international acceptance business is being carried on, except that the timing of the purchases and sales of sterling

are reversed. Instead of the proceedings starting with a sale of sterling by a foreign discounter, offset by a later purchase of sterling, the foreigner now buys sterling first, while the market authorities sell sterling in order to offset the market liability.

If this alteration in the timing of influences exerted upon sterling was the only important change in the general situation, no special problem would be created. Unfortunately, however, the situation is more complicated than this. We have noticed that strict principle requires that the Central authority should, while the foreign deposits are being built up, acquire gold and foreign exchange in proportion to the increasing liability of the market. If it follows this policy, what is it to do with the gold and exchange acquired? The answer depends upon the circumstances which lead to the entry of the foreign deposits into London. If they are the result of some genuine disequilibrium between British and foreign costs, which shows itself in a relatively high level of money rates in London, the entry of the deposits will give the Central Bank the opportunity to acquire the gold which it needs to increase the credit structure, to lower money rates and to raise the level of costs and prices in conformity with normal gold standard procedure. Gold acquired under these circumstances will be added to the ordinary reserves of the Bank, the influx of deposits will be checked by the downward tendency of money rates; and, if the whole operation is conducted with skill and judgment, the foreign deposits will leave in small driblets, being offset as they leave London, not by an export of bullion which would demand internal contraction, but through the normal operation of the balance of payments.

The difficulties arise not when the movements of foreign balances are due to some disequilibrium between the credit structures of London and the rest of the world, but when foreigners desire to increase their balances in London, either because they suspect the stability of other currencies, or when they wish to hold funds in London as additional cash reserves for the better conduct of their ordinary banking business, as, for example, under the gold exchange standard system. If, in the case where foreign balances are being acquired because of fear felt for other countries, London tries to increase its holdings of gold and foreign exchange in proportion to its increasing deposit liability, it may precipitate a crisis abroad by depleting the cash resources of the suspected currency system. Under normal gold standard procedure, the loss of gold felt by the suspected centre will induce a local deflation, while the additional gold in London will increase the supply of sterling and bring about an upward movement in the British cost and income structure. There will be a tendency towards an exaggerated disequilibrium between British prices and those of other countries which will weaken the balance of payments and superimpose upon the already unstable international position further difficulties arising from the British "inflation". When, therefore, foreigners desire balances in London as an insurance against weakness in their own currencies, there will always be a danger, under orthodox gold standard practice, that disturbances will actually be increased rather than diminished by the movements of funds that take place. If London does nothing to fortify its position, it may have difficulties in meeting its liabilities. If it simply increases its holding of gold and foreign exchange, it

may bring about a disturbance in British prices and costs which is undesirable.

Difficulties of the same sort arise in the case where foreigners desire to hold sterling balances as additional reserves, not because they fear the stability of their own currencies, but because cash reserves in a central money market such as London are more useful than idle cash balances in small and remote banking centres. These balances are built up, not because the centres acquiring them are increasing their indebtedness to Great Britain owing to a shift in the balance of payments, but because they are carrying an increased volume of trade with the world at large and desire to hold increased international balances. If, under these circumstances, the British monetary authorities, in order to offset the increasing external liabilities of the market, increase their gold holding in the ordinary way, they will enlarge the British credit structure and will tend to disturb the British balance of payments. If this should occur upon a substantial scale, the weakness of the pound will reduce the value of balances in London to foreigners, and may result in a substantial sale of sterling due to realisations of foreign balances at a time when the British balance of payments is negative. Such a conjunction of forces may well result in a movement of gold out of London out of all proportion to that needed to bring about the deflation necessary to adjust the balance of payments, and the whole gold standard system will be imperilled.

It appears, therefore, that so long as London practises international deposit banking instead of acceptance business, a policy of "offsetting" similar to that carried on by the Exchange Equalisation Account will be necessary as a normal feature of British

monetary policy. "Offsetting" means the acquisition of gold and foreign exchange without a corresponding increase in the credit structure in Great Britain. The principles upon which such a policy should be conducted require further consideration, particularly as it appears to have been followed in a tentative manner by the Bank of England itself after the return to the gold standard in 1925. This conclusion is to be drawn from the evidence given by Sir Ernest Musgrave Harvey before the Macmillan Committee in 1930 when he claimed on behalf of the Bank that it had reduced the difficulties of the time by offsetting as a result of open market operations any depletion in the resources of the market caused by exports of gold. Professor Gregory has shown that this policy was adopted in 1925–6,[1] and the evidence before the Macmillan Committee as well as the Bank's published figures suggest that it was followed consistently both before and after the breakdown of the gold standard. We have already seen that there are under certain special conditions sound reasons for following such a policy of offsetting. If the loss of bullion is due to the withdrawal of balances, and *if these balances were sterilised at the time of their entry*, offsetting is the only sound procedure to be followed. But the procedure is dangerous and requires the greatest possible degree of skill if it is to be wisely used. There must be no confusion between a loss of gold due to disequilibrium between prices and costs here and abroad, or to excessive foreign lending or purchase of securities and a loss that arises from a withdrawal of foreign balances. Moreover, if the foreign balances which are withdrawn have had any influence upon the level of

[1] T. E. Gregory, *First Year of the Gold Standard*, p. 86.

money rates in London, and if their withdrawal, were it not offset, would tend to cause these rates to harden, then the policy of offsetting should not be followed. The result of failing to neutralise foreign balances when they enter the market is to make their subsequent withdrawal an export of capital which should be allowed to have its normal influence upon the exporting centre. In the period 1925–31 the foreign deposits in London did have a positive influence upon the money market. They were not offset by a special reserve but were used to keep down the costs of refinancing Treasury bills and short-term Government securities. As these made up a large proportion of the whole internal debt, changes in the cost of financing them had important repercussions upon the Budget and the whole internal economy of Great Britain. Hence, there was a great temptation to the Bank to offset by purchases of securities in the market any withdrawal of foreign funds which caused a realisation of Treasury bills and short-term securities and raised the cost of Government refinancing. This temptation is likely to be always present if the policy of offsetting is to be followed; and it will be most difficult to resist just at those periods when its capacity to do harm is at a maximum, that is, at the top of a boom when short money rates tend to be high. At times such as these, it will be particularly easy to mistake a withdrawal of funds due to basic disequilibrium for a realisation of foreign balances which may be offset. The Government will already be preoccupied with the disturbing influence of high short-money rates upon the Budget charge for the service of its debt, and will be unwilling to add to taxation or to face a deficit at a time when a boom is beginning to collapse. The temptation to offset will be almost

inescapable under such circumstances. It is, therefore, very important that the circumstances requiring offsetting should be carefully examined, and that the organisation charged with the responsibility for doing this work should be independent of Government control and should work in the closest possible co-operation with the Bank of England.

Offsetting can only be safely carried out if it starts when the volume of short-term foreign deposits is increasing. To offset when they decrease, without previously offsetting increases, must ultimately be disastrous. Let us assume, therefore, that the Central authorities have sufficient information to enable them to measure with fair accuracy the rate at which foreign deposits in London are increasing, and that, in the light of this knowledge, they decide to acquire sufficient gold or foreign exchange to offset the increase. They must do so without allowing their purchases to be used as a foundation for internal credit expansion. We first examine the problem under artifically simplified conditions in which the balance of payments is neutral and the sole disturbing factor is an increase in foreign balances in London. British banks, as a result of receiving foreign deposits, are acquiring foreign currencies. Their own cash position is unaltered, there is no increase in their liquid resources, but the ownership of a part of their deposits has changed. If they are left with the foreign currencies on their hands, they will probably sell them, and by so doing they will push the sterling exchange up to its gold import point; they will then import bullion, and by selling it to the Central Bank they will increase their own sterling resources. Having done so, they will be able to increase the local credit structure and undesirable consequences may

follow. Before this occurs, therefore, the Central authority must acquire the foreign currency from the banks, but to do so it will have to sell sterling, and to sell sterling to the ordinary banks in exchange for their foreign currencies will increase their cash resources in the same way as if they had been permitted to exchange their foreign holdings for gold and to convert the gold into cash at the Bank of England. To prevent this occurring, the Central authority must, by a sale of securities in the market, acquire sufficient sterling to enable it to purchase the foreign balances of the ordinary banks. These sales of securities will decrease the cash resources of the market, but the contraction will have no lasting influence because the funds will be put back into the market again as the foreign currency is purchased.

We have now to consider the form of organisation which is necessary to permit such a policy of offsetting to be carried out as part of the normal working of an international monetary standard. It should first of all be noticed that such a policy is likely to be needed more in London than in any other international centre. This arises partly from the importance of London as clearing-house for short-term international payments of all kinds, and partly because the whole mechanism of London is more highly "geared" than that of any other centre, so that a movement of bullion or of short money rates tends to have a wider influence here than a comparable movement elsewhere. This greater sensitiveness of the British system and the international importance of London's monetary policy makes it highly desirable that the system shall, for the future, be so organised as to make it quite clear exactly what policy is being followed by the London authorities,

both in respect of internal credit conditions and external monetary movements. If the Central authority in framing its policy is to distinguish between those movements which require offsetting and those which are to be allowed to have their usual influences, it must also be possible for others to see and to follow what is being done. This consideration makes it undesirable to return to the old method by which the Bank, by changes in its holdings of "other securities" in the Issue Department or Government securities in the Banking Department, carried out either external or internal offsetting open-market operations. The offsetting must be done when foreign balances enter; this means that foreign currency must be acquired and held by the Bank. It can hold such currencies as "other securities" in the Issue Department and leave the figures that are relevant to internal credit conditions unchanged. But if it desires to bring part of its holding of foreign currencies home, it must import gold, and if it does this, either the Fiduciary Issue must fall below its legal maximum or, more probably, the reserve of the Banking Department must be allowed to increase. If the movement of balances is upon a large scale, the Banking Department's proportion may become very high, and quite apart from the effect that this would have upon the profits of that Department, it is highly desirable that changes in the proportion should reflect the Bank's policy with regard to internal and not to external conditions. If the present organisation is retained unchanged, it is probable that future variations in the proportion will be on a large scale when the Bank does not desire internal conditions to be altered by changes in foreign balances, but only upon a small scale when it desires internal adjustments to take place. The practical

value of the Bank's weekly returns will be seriously diminished.

It is, therefore, desirable that there should be some changes in the existing organisation. Either the recommendation of the Macmillan Committee that the two Departments should be reunited can be adopted, or the present Banking Department can be left as it is and the Note Issue Department modified by absorbing into it the Exchange Equalisation Account. Before we can decide between the merits of these two alternative proposals, it is necessary to re-examine the circumstances under which short-term capital movements occur with the simplifying assumption which we made above removed. It will be recalled that we assumed that the increased holding of sterling deposits by foreigners was the sole disturbing factor to be considered and that the British balance of payments was in equilibrium. In reality, so simple a case is not likely to occur. There is likely to be some disequilibrium in the cost structure which will demand a modification in the internal credit structure, and also some profit or loss on the balance of payments which will require foreign lending or borrowing. These factors will add substantially to the difficulties of the authorities. If the British credit structure needs expansion, and if there is a surplus to be lent abroad, a twofold movement will have to occur simultaneously. To meet the first requirement, there will have to be some increase in the cash resources of the market, and to meet the second, there will have to be a downward movement in the long-term interest rate to encourage foreign borrowing. Both these things can be most simply brought about by an import of gold which causes an increase in market resources and a lowering of money rates. But at the

same time, to cover the deposit liability there will have to be special imports of gold which are not allowed to have any direct influence upon internal conditions.

With this in mind we can re-examine the alternatives of re-amalgamating the two departments of the Bank of England, and of retaining the Exchange Equalisation Account, preferably as part of the Issue Department of the Bank of England itself, to hold gold and foreign exchange in proportion to the market's external deposit liabilities. If the first alternative is adopted, the weekly statements of the reformed Bank of England will need extensive interpretation before they can be any guide to the market and others interested in them. In the first place, the significance of changes in the ratio between liabilities and cash assets—that is, gold and foreign exchange—will be relevant sometimes to internal and sometimes to external conditions. If the former, they will foreshadow easier internal monetary conditions; if the latter, they will indicate no such change. As movements relating to increases in gold as a result of a growing external deposit liability will probably be upon a greater scale than those relating to internal conditions, the Bank of England returns as a guide to market policy will be very uncertain, if not altogether useless. This difficulty might be overcome if the publication of the return of the new consolidated Bank was accompanied by a table showing changes in the external deposit liability of the market, and by a note explaining the relationship between the changes in this liability and alterations in the gold and foreign exchange holding shown in the Bank return. The periodical publication of data of this sort has something to commend it, but it could not be quite as complete or accurate as the weekly return of the Bank. And as a guide

to the market in carrying on its normal business such data would be of little value. Even after the market had gained sufficient experience of it to be able to interpret changes that occurred in the data from time to time, the wisdom of publishing an index of foreign deposits must be questioned, as the character of the deposits is not uniform, and the purpose for which they are held in London varies considerably. Some of them represent the building up of sterling balances for ordinary trade and financial purposes, such as the meeting of obligations incurred in previous purchases of goods, or the accumulation of sterling to pay off maturing loans. A very considerable degree of judgment and of detailed knowledge would be necessary before any intelligent interpretation could be made of a figure showing the net deposit liability of the market on any occasion. But without such a figure the significance of changes in the weekly return of a reconsolidated Bank of England would be extremely difficult to interpret.

This difficulty can be avoided if the Banking Department is left unchanged, and if the Issue Department is reorganised and the Exchange Equalisation Account absorbed into it. At present all notes issued are "in circulation" or "in the Banking Department", and all increases in gold bullion in the Issue Department lead to increased note issue, though not necessarily to increased circulation. What is needed is a system by which the Bank may at will discriminate between a movement of bullion which will result in an increase or decrease of notes issued, and those which do not have these effects. If the Bank itself could take the initiative in importing or exporting bullion and could operate on its own account, there need be no changes in the note

issue as a result of the gold movements. Now it is precisely at times when balances are either increasing or decreasing and need to be offset that dealings in bullion by the Bank acting on its own account would be valuable, particularly if the Bank through its Issue Department—the profits of which accrue to the Government—was to operate just before the exchanges reached their gold import or export points.

The system would work along the following lines: The Bank of England, either from returns sent in from the market or by general observation, would notice that there was a tendency for the deposit liability of London to increase, and consequently for the exchanges to turn in favour of London. This knowledge would enable it to form an opinion as to whether the circumstances required an internal expansion of credit. If this conclusion was reached, the exchanges would be allowed to reach gold-import point, and a movement of bullion would result in the usual way in an increase in the gold held at the Bank, an increase in the note issue and the proportion of the Banking Department, and an accompanying increase in the cash resources of the market. If, however, the Bank did not wish for any change to occur in internal monetary conditions, it could itself, working through the Issue Department, operate in much the same way as the Exchange Equalisation Account has done. Just before the exchanges reached gold-import point it could sell some of the Treasury bills held in the Issue Department and purchase foreign exchange. If it wished to bring the gold home it could do so and hold it without issuing notes against it. It would have changed the form of its assets, the gold replacing the Treasury bills previously held, but internal conditions would not

be changed. It is true that, to get the sterling necessary to buy the foreign exchange, it would have to reduce the market supplies of cash by selling bills, but the purchase of foreign exchange would immediately replenish the market supplies of sterling and the final effect upon the market's resources would be nil. In the same way the reorganised Issue Department could sell gold when foreign balances were decreasing, first shipping the gold and purchasing foreign exchange with the proceeds, then selling the foreign exchange for sterling and then using the sterling to purchase bills in the market. Again, the whole transaction would leave the condition of the market unchanged. Some bullion movements would thus be initiated directly by the Bank of England itself, but only when the Bank desired to facilitate movements in foreign balances without any disturbance of either the exchanges or of supplies of credit in the market. It would exercise its right to deal in gold when it desired to follow an offsetting policy; it would leave the present system to operate when it desired internal credit conditions to be influenced by the normal gold-standard procedure. The acquisition of this right by the Bank of England would be a substantial improvement on the monetary mechanism of London; it would, of course, have to be exercised with the greatest discretion and only when it was clear that offsetting was necessary.

Very little change either in law or in the organisation of the Bank itself would be necessary to enable it to exercise this added responsibility. The Issue Department could take over the assets of the Exchange Equalisation Account, paying the Government by an issue of special preference capital secured against the assets of the Issue Department. As the Government is

now entitled to the profits realised on this Department, such an issue of capital to the Government by the Bank would serve only to regularise the present position. It is improbable that all the present assets of the Exchange Account would necessarily be transferred.

Let us suppose that £200 million is sufficient for the purpose of giving the Issue Department a supply of Treasury bills to enable it to carry out such offsetting operations as may be necessary. Let us further suppose that the assets of the Exchange Account on the day when the transfer is made total £350 million, of which £100 million is in the form of gold and devisen and £250 million in Treasury bills. The gold and foreign exchange—let us suppose that there is £50 million of each—would be transferred to the Bank together with £100 million of Treasury bills. The remaining £150 million of bills would be returned to the Treasury and cancelled.

Ignoring for the moment the question of the re-valuation of the gold bullion held in the Issue Department at the present time, a question which will be discussed in the next chapter, the return for the Issue Department, taking the figures for the week ended May 2nd, 1934, as a model, would be changed in the following way:

*Present Return*

| | | | |
|---|---|---|---|
| Notes issued— | | Government debt . | £11,015,100 |
| In circulation . | £378,508,821 | Other Government securities . . | 244,371,414 |
| In Banking Dept. | 72,724,369 | Other securities . | 1,152,671 |
| | | Silver coin . . | 3,460,815 |
| | | Amount of Fiduciary Issue . . | 260,000,000 |
| | | Gold coin and bullion | 191,233,190 |
| | £451,233,190 | | £451,233,190 |

*New Return*

| | | | |
|---|---|---|---|
| Preference capital | £200,000,000 | Government debt . | £11,015,100 |
| Notes issued— | | Other Government securities . . | 344,371,414 |
| In circulation . | 378,508,821 | Other securities . | 51,152,671 |
| In Banking Dept. | 72,724,369 | Gold coin and bullion | 241,233,190 |
| | | Silver coin . . | 3,460,815 |
| | £651,233,190 | | £651,233,190 |

The fixed Fiduciary Issue should disappear as it will no longer be necessary. As the Bank will still be obliged to buy and to sell gold at fixed prices, changes in notes in circulation and notes in the Banking Department will only take place as the result of market sales and purchases of gold to and from the Issue Department. But the Bank itself could, if it wished, change the assets held in the Issue Department for gold or foreign exchange ("other securities") into other Government securities and *vice versa* by dealings in bullion on its own account inside the limits of the gold points. Changes in the Bank return will thus be plain and clear for all to read. Alterations in bullion which result in changes either up or down in the number of notes issued will be the normal response of the banking system to favourable or adverse movements in the exchanges caused by some disequilibrium which needs correcting. Changes in bullion which do not influence notes issued will reflect action by the Bank to offset increases in external deposits if the quantity of bullion increases, or decreases if it decreases.

The absence of a fixed Fiduciary Issue need not cause any alarm. Changes in internal supplies of notes both in circulation and in the Banking Department will take place as they ought to do in response to movements in the exchanges. Only when the exchanges

are allowed to reach the bullion import or export points will there be changes in notes issued. It will still, however, be possible to retain a certain discretionary power in the hands of the Chancellor of the Exchequer, subject to reports to Parliament, to enable him to meet any emergency by what would under present circumstances be met by an increase in the Fiduciary Issue. Situations in which the exercise of this power is most likely to be needed will arise when a crisis develops with the exchanges already at gold-export point so that there can be no relief to internal conditions as a result of an import of gold. The Banking Department could meet such a situation in part by allowing its reserves proportion to fall, but if a further increase in its cash became necessary the Issue Department could buy Government securities from the Banking Department in exchange for notes. There would thus be an increase in notes issued without any increase in the bullion held by the Issue Department. This would be "abnormal" and would require sanction, and would presumably be only temporary in character, as the Banking Department would not wish to see a reduction in its proportion of income-earning assets.

This proposal is a very simple one and requires very little change in present practice. Under the fixed Fiduciary system any alteration in the total of notes issued can only take place as a result of movements of bullion in or out of the Bank. There is a fixed basic supply of currency which can only be altered as a result of movements in the exchanges. All such movements, in so far as they lead to changes in the quantity of bullion held by the Bank, must result in changes in note issue. Under the proposed system, these movements would still take place and would have their

normal influences, but, in addition, the Bank could itself take the initiative and alter the proportion between the holding of Government securities and bullion in the Issue Department without altering the quantity of notes issued. In the past it has on several occasions had to offset movements in gold which in its view ought not to be allowed to influence internal credit conditions. The difficulty was that it could not deal in bullion without influencing the note issue, and its offsetting operations could not be clearly and readily understood by the market. If the Issue Department is reorganised as is suggested here, it will be in the future far simpler to see what policy the Bank is following. If it is offsetting short-term capital movements, changes will take place in the figures for gold and Government and other securities in the Issue Department; if it is allowing the normal gold-standard machinery to influence internal conditions, changes may occur in the figures for gold and for note issue and will occur in the figures for the Banking Department. There will be no substantial change in practice, only a simplification of machinery in the interests of greater clarity.

The costs of this proposed change will fall upon the Government, as they will influence the profits of the Issue Department. It is not easy to say whether over a period of years the profits made will be greater or less than they have been in the past. As, however, it is desirable that the liquid assets of the London Market should be increased, it is probable that on the average, year in and year out, a larger proportion of gold will be held than has been the case in the past, although it is much to be hoped that, with more stable international monetary conditions, and with the develop-

ment of the technique of managing international deposit banking, the quantity of bullion necessary may be diminished. This point is discussed in its rather wider aspects in the next chapter. For the next few years it seems reasonable to suppose that profits in the Issue Department will be somewhat lower than formerly, because of the increased holding of gold. As the Department may also have to purchase gold bullion below the gold-import point and sell it above the export point, it will have a smaller margin of profit on each individual bullion transaction than the private trader can obtain, and this also will slightly reduce its profits. But as, unlike the private trader, it will expect to be able in the long run to pair off inward and outward movements of gold against each other, reductions in profit as a result of its operations inside the bullion points should be practically negligible. As, however, the earnings of the Department will in any year depend upon the degree upon which it may be necessary to deal in bullion during the period, and also the average proportion of non-income earning assets held in gold during that year, it will not be possible for it to pay a fixed dividend to the Government upon the preference capital which the State will hold. Moreover, the State will have to guarantee the Department against any losses due to depreciation of its securities which may arise. But the difficulties arising in connection with both these points are not very serious ones. The Issue Department will earn substantial sums in interest on its holdings of Government securities, although this will fluctuate conversely with its holdings of bullion. Profit will depend upon the proportion between gold and bills, and the whole question of profit or loss will be mainly a matter of

book-keeping. Unless a substantial fall in the sterling price of gold is to be anticipated, the sterling losses of the Department are never likely to be very great in any one year and can be carried in a suspense account to be offset in more favourable years. There should, therefore, be no danger in the Treasury retaining its present rights and liabilities so far as the profits and losses of the Issue Department are concerned. Should there be any fall in the average of realised profits, this will be due to the increased holding of foreign exchange or gold. As the Macmillan Committee reported that the reserves of the money market ought to be increased in the interests of the country as a whole, it is only right that the small annual costs involved should fall upon the National Exchequer and not upon any one section of the community.

# CHAPTER VIII

## STABILISATION

IN the last chapter we discussed the possibility of absorbing the Exchange Equalisation Account in the existing organisation of the Bank of England so as to enable the offsetting of changes in foreign balances to be carried on as a permanent policy with the object of improving the monetary mechanism of London. The reorganisation involved will be difficult to carry out so long as the pound is unstable, as the variations in the price of gold and foreign exchange, which are a feature of a régime of unstable exchanges, make the whole scheme difficult to work. The present system of a separate account with its prerogative of secrecy will necessarily be retained until effective stabilisation is possible. The proposal of absorbing the Account into the Issue Department of the Bank of England does, however, provide a working solution of a number of problems which will arise when the moment for stabilisation is reached, and will reduce the risks necessarily involved in re-adhering to the international money standard. Stabilisation, instead of limiting the freedom of action of the British monetary authorities, may actually increase it if the policy of absorbing the Exchange Equalisation Account into the Issue Department of the Bank of England is adopted.

The date at which, and the exact circumstances under which, stabilisation should be achieved do not

concern us here. Events in other countries must play so large a part that it is not possible in the early summer of 1934 to say what combination of events will create the opportunity which should be seized by the British Government for the re-establishment of stable exchanges. Nor is it possible at the present moment to discuss the rate at which the pound should be stabilised. That must depend upon the circumstances existing at the selected date. For the purpose of discussing some of the technical problems involved, however, a figure of 140s. per fine ounce as the new price for gold is used in this chapter, but there is no suggestion that this is the precise figure which ought to be adopted.

Assuming the new parity to be correctly determined, the two most important outstanding problems will be to discover the size of the note issue which will be appropriate to the new gold value of the pound, and the size of the gold reserve which will normally be required to guarantee the satisfactory management of the new parity. It is unlikely that the general tendency to higher prices which should follow stabilisation will require any large change in the note issue of this country, but more active general employment, which will be made possible when international capital movements are resumed, may make a slightly higher note circulation desirable. This being the case, the first period of stabilisation should be regarded as an experimental one, with a tolerable degree of elasticity in such regulations as may be made for the future control of the note issue.

A similar period of experience in working the new system will be needed before it will be possible to determine the upper and lower limits of the gold reserve which should normally be kept in London. Post-war

experience is of no great value in settling this point, and recommendations of both the Cunliffe and the Macmillan Reports will be irrelevant to the new conditions. If too much gold is kept permanently in London the benefits of stabilisation will be reduced. It is unnecessary to enlarge upon the danger of keeping too low a reserve, particularly in the early days of stabilisation.

The proposal that the Exchange Equalisation Account should be absorbed into the Issue Department of the Bank of England, and its assets merged with those already held by that Department, will provide the necessary freedom of action to the authorities in respect of the note issue and the gold reserve without reducing their power to take the appropriate action necessary to maintain the stability of the exchanges. How this proposed amalgamation will give this freedom of action can best be seen by examining a series of figures representative of the situation of the amalgamated department as it may be supposed to exist at the date at which stabilisation is decided upon. Let us suppose that the Exchange Account holds gold, valued at the new parity price, worth £50 million, devisen worth £50 million and the balance of its assets in Treasury bills. The return of the Issue Department at the stabilisation date may be presumed to be as follows:

| | | | |
|---|---|---|---|
| Notes in circulation | £380,000,000 | Government debt . | £11,000,000 |
| Notes in Banking Dept. . . | 70,000,000 | Other Government securities . . | 244,000,000 |
| | | Other securities . | 2,000,000 |
| | | Silver coin . . | 3,000,000 |
| | | Fiduciary Issue . | 260,000,000 |
| | | Gold coin and bullion | 190,000,000 |
| | £450,000,000 | | £450,000,000 |

The first step is to revalue the gold coin and bullion at 140s. instead of 85s. per fine ounce. This changes the £190 million into approximately £315 million, so that the new return after this revaluation and the absorption of the Exchange Accounts Assets will read:

| | | | |
|---|---|---|---|
| Capital . . | £200,000,000 | Government debt . | £11,000,000 |
| Notes in circulation | 380,000,000 | Other Government securities . . | 344,000,000 |
| Notes in Banking Dept. . . | 70,000,000 | Other securities . | 52,000,000 |
| Profit of revaluation | 125,000,000 | Silver coin . . | 3,000,000 |
| | | Gold coin and bullion | 365,000,000 |
| | £775,000,000 | | £775,000,000 |

The profit realised on the revaluation of the gold accrues to the Government, and it should be used to cancel the Government debt to the Bank. The old debt of £11 million might well be allowed to disappear (as the cost of printing in perpetuity this separate item in the weekly return outweighs the historical associations connected with it), and a further £114 million of Government securities held by the Bank might be cancelled and the National Debt reduced accordingly. The consolidated balance sheet would then be:

| | | | |
|---|---|---|---|
| Capital . . | £200,000,000 | Government securities . . . | £230,000,000 |
| Notes in circulation | 380,000,000 | Other securities . | 52,000,000 |
| Notes in Banking Dept. . . | 70,000,000 | Silver coin . . | 3,000,000 |
| | | Gold coin and bullion | 365,000,000 |
| | £650,000,000 | | £650,000,000 |

The holding of gold and foreign exchange would exceed £400 million. £100 million of this sum having been, as we assume, taken over from the Exchange Equalisation Account, would be held to offset existing foreign balances in London. Deducting this £100 million, we

are left with a "free" gold holding of £315 million. It is the size of this figure which will give the authorities their freedom of action in the first period after stabilisation. If experience shows that the average movements in external balances are smaller after stabilisation than they were in the post-war period, it will be a relatively simple matter for the Issue Department of the Bank itself slowly to reduce its gold holding until a figure is reached which is, in the opinion of Parliament, adequate for the purpose of providing a special reserve against changes in the quantity of foreign deposits in London as well as the normal reserve to be used in the ordinary way when the exchanges are adverse to this country.

If experience shows that the note issue at the stabilisation date is insufficient to support with an increased volume of employment the internal price-level which will be appropriate to the new parity, there will be no serious obstacle in the way of increasing the note issue within moderate limits at the discretion of the Chancellor of the Exchequer and subject to an affirmatory vote by the House of Commons. Indeed, the statute enabling stabilisation may well provide for special elasticity in the note issue during the first five years, or some similar period, after it is passed. Alternatively, the statute might fix a maximum for note issue which the Bank could reach without further importation of gold and subject to the provision that the note issue should not be increased at times when the Bank was actually losing gold or when the exchanges were adverse. This provision would prevent any danger that might arise from the pound being stabilised at too low a parity, and causing a quite unnecessary influx of gold in order to increase the note issue to bring

the British system into equilibrium with the rest of the world. It is presumed that after the experience of 1925 there is little danger of too high a parity being adopted.

In these ways the reorganisation of the Issue Department will make it possible for the British monetary authorities to preserve considerable freedom of action even after the exchanges have been stabilised *de jure*. They will be in an entirely different position from that in which they found themselves in 1925 when sterling had been over-valued as a result of an accumulation in London of external balances which had not been "offset". At that time supplies of gold and foreign exchange, excluding the New York credits, were not sufficient to permit very large-scale realisations of foreign balances without internal repercussions. The present position is entirely different, as a part of the balances now in London have been offset as they entered the market by the operations of the Exchange Account. They can be withdrawn without any very serious disturbance, so that instead of being left with a shortage of gold at the time of stabilisation, as was the case after 1925, the Bank will probably find itself with a surplus.

This places the whole question of the desirability for stabilisation in an entirely new light. Instead of being a defensive measure carried out at considerable risk, as was largely the case in 1925, it ought now to be considered as the only practical attack upon the international economic difficulties which threaten to check the recent industrial and economic recovery of this country. Our policy since 1931 has been defensive, indeed protective, in character, and this is as true in the monetary and financial spheres as it has been in the

industrial. The policy of the Exchange Equalisation Account and the whole paraphernalia of offsetting short-term capital movements has been nothing more nor less than "hoarding" upon a gigantic scale. The London money market, for the first time since it became an international banking centre, has been compelled to adopt a deliberate policy of refusing to use the moneys entrusted to it. Before the suspension of the gold standard, it tended to lend long more money than it had borrowed short; this policy proved to be suicidal when the pound was over-valued. During the past two years the pound has been under-valued and foreign balances have been sterilised. We have jumped from one extreme to the other, and by doing so have made the consequences of the first error worse than they need have been by embarrassing to an unnecessarily severe extent our debtors. Mr. Graham Hutton, speaking in 1930, said: "The anarchy of the present system together with its recumbent apathy to any form of foreign lending will, if ignored, lead to a kind of apoplexy of the capitalistic economy—congestion at the centre and anaemia at the extremities".[1]

The policy of offsetting and stabilisation has increased both the congestion and the anaemia. The degree of congestion in London will become clear at stabilisation, and is suggested by the figure which we have used above to show what the cash position of a reorganised Bank of England may well be when stabilisation is finally decided upon. The ultimate test of the policy which has been followed since the establishment of the Exchange Equalisation Account will be in the

[1] Mr. D. Graham Hutton in *The International Gold Problem* (p. 192), published by the Oxford University Press and issued under the auspices of the Royal Institute of International Affairs.

use which London can make of its improved monetary position. The size of the revalued gold holding, for example, should make it possible for London to adopt a deliberate policy of disgorging some of its idle cash by a systematic policy of overseas financing. A carefully constructed policy is necessary. It should be designed to ease the burden on present overseas debtors, to expand backward territories likely to be able to absorb part of the low-grade industrial products which have competed severely with our own goods in recent years, and to increase the volume of British exports of capital goods, particularly to those countries which have been able to do little or nothing by way of re-equipment or reconstruction since the beginning of the depression. Such a policy cannot be worked out and applied in a hurry, but a general acceptance of the need for such a policy and its practicability would do a great deal to restore international confidence and to begin once again those movements of capital which are the first essential for further recovery.

Such a policy will fail, or at the best lead to a temporary recovery, if there is any doubt as to the financial strength of London. The merging of the Exchange Equalisation Account with the Issue Department of the Bank of England should make the true position clear. Careful control of the note issue, and the release of such gold as experience shows to be redundant, will be necessary in the early period until the general international recovery gives once again to this country the only sure foundation upon which it can rest, an active and growing world trade. Tariffs, quotas and other restrictive measures are plausible devices when world trade is contracting; they lose their attractiveness when it is possible to adopt an expansionist

instead of a defensive policy. For the first time since the war this country has the opportunity to adopt such a policy with reasonable prospects of success. The policy of the Exchange Equalisation Account has reduced the risks of such a policy to a minimum. If we wait much longer before we adopt it we may find that further delay has reduced the opportunities also.

THE END

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